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THIRD WORLD DEBT LEGISLATION

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

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THIRD WORLD DEBT LEGISLATION

WEDNESDAY, MARCH 12, 1986

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:05 a.m., in room 2220 of the Rayburn House Office Building, Hon. Stan Lundine (chairman of the subcommittee) presiding.

Present: Chairman Lundine; Representatives LaFalce, Levin, Bereuter, and McCandless.

Chairman LUNDINE. Good morning. Today is the first in a series of what will probably be four hearings which the Subcommittee on International Development Institutions and Finance will hold to solicit reaction from expert witnesses on proposed legislation addressing the international debt problem.

This legislative initiative is the outgrowth of the extensive hearings held by this subcommittee during 1985. Throughout these hearings, we heard two major recurring themes—that the debt crisis poses a grave threat to the continued health of the world trading system and to the international financial system.

The United States is the world's largest economy. We have borne the brunt of the developing countries' debt problems since 1982. That is nowhere more obvious than in the massive trade deficit that this country is presently accumulating.

To deal with their debt burdens, the debtor nations have drastically reduced their imports of products. Developing countries were once our most promising markets. Since 1982, they have been a major component of our trade deficit. In the financial sector, U.S. commercial banks have billions of dollars in loans outstanding to the developing world. These debts threaten the soundness of our banking institutions and make it imperative that we do all we can to make the problem more manageable.

The October announcement by Secretary Baker in Seoul, Korea, of a plan to address the debt crisis went a long way toward restoring an appropriate leadership role for the United States in solving this problem. U.S. leadership is appropriate precisely because we have so much to lose if the debt crisis is not addressed with the necessary urgency.

The goal of this legislation we're beginning to consider is not to take U.S. policy in a different direction from the Baker plan but to implement and advance what the Secretary has proposed. The Baker initiative correctly identifies the more important role which

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must be played by the international financial institutions, particularly the World Bank and the Inter-American Bank. This legislation reinforces the need for the World Bank to lead and coordinate international efforts to resolve the debt crisis.

The Baker plan also recognizes the importance of economic reform by the developing countries themselves. We concur and we advocate the use of World Bank resources to promote trade liberalization, strengthen the financial sector, and foster other reforms in these economies.

Finally, the Baker plan calls on the commercial banks to remain players in the game. The legislation that I have drafted and asked for comments about recognizes the need for the commercial banks to continue to provide capital to developing countries.

The need for legislative and executive action on the debt problem is even greater than it was last fall. Events, particularly with regard to Mexico, have moved beyond what was discussed in our hearings of a year ago and at Seoul by Secretary Baker. Those events reinforce the conclusion that more must be done to contain the debt problem.

The legislative initiative being considered before the subcommittee represents an effort to develop some creative solutions to the debt crisis. I would not pretend that it's a perfect document. In fact, I look forward to the constructive criticism and additional suggestions which we will undoubtedly hear during the course of these hearings.

Our witnesses today include William Cline, John Sewell, and Karin Lissakers. Mr. Cline is a senior fellow at the Institute for International Economics. He was formerly with the Brookings Institution and has done a great deal of work in recent years on the debt problem.

Mr. Sewell is president of the Overseas Development Council. John is organizing an ODC study due to come out in June on the future course of the World Bank.

Ms. Lissakers is formerly Deputy Director of the Policy Planning Staff at the State Department and is presently completing a book on commercial banking.

Mr. Bereuter, do you have an opening statement?

Mr. BEREUTER. I do, Mr. Chairman, a brief statement.

Mr. Chairman, it's a distinct pleasure to join you in welcoming the distinguished panel that we have at the first hearing on this subcommittee's review of the international debt problem. I look forward to their testimony and comments.

I want to commend you at this stage, Mr. Chairman, for your thoughtful and provocative draft legislation that we have before us. You know as well as I the difficulties that most of us have in drafting legislation that has little or no budgetary impact.

What you put before us is an important proposal that enhances the stature of our subcommittee and your own. And I understand that it's said to be Gramm-Rudman-Hollings neutral. [Laughter.]

Now that's a major accomplishment.

Parenthetically, I would say that perhaps the leadership of the Library of Congress could take some lessons from you instead of engaging in the budgetary demagogery they're engaging in now. And I speak about our employees.

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In reading your draft proposal, Mr. Chairman, I can say that I certainly agree with most of your suggestions. Some of them I am hesitating on because I simply don't have at this point the knowledge that I need to have to react to them.

I am therefore looking forward to the comments from our panel today.

I do have to say in advance that while I regret the fact, the timing, the Financial Institutions Subcommittee is holding hearings on the problems of agricultural banks today and I am testifying because of the problems of the banks in the Grain Belt. So I will have to leave a bit early.

Let me say in closing that I certainly believe that these hearings are timely and important. Though the debt crisis continues to become more and more important with each passing day, it seems as if the energy and the hope that was generated after Secretary Baker's speech in Seoul, Korea, has, to some extent, dissipated. This should not be allowed to happen.

I would hope, Mr. Chairman and Members of the committee, that our hearings will inspire some of the key actors and international leaders to redouble their efforts.

Thank you very much.

Chairman LUNDINE. Thank you, Mr. Bereuter.

Mr. Cline, would you begin?

STATEMENT OF WILLIAM R. CLINE, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. CLINE. Thank you, Mr. Chairman.

I would like to submit my written testimony for the record and to make a summary.

Chairman LUNDINE. Your entire testimony and that of the other witnesses will be made a part of the record, and we would appreciate any summaries that you can make.

Mr. CLINE. Thank you.

I would like to begin by focusing on the World Bank and on the rather modest contribution that it has made in the initial stage of the debt crisis.

If you consider the 15 Baker plan countries, the World Bank's net disbursements to these countries, right before the debt crisis and right after, rose from only $1.8 billion a year to $2.8 billion a year. Now that's a large proportionate increase. Relative to a cutback of private bank lending of something like $20 billion, it was modest.

And in contrast, the International Monetary Fund increased its lending to these countries by about $5 billion in 1983.

The problem is that the International Monetary Fund is now in the phase of its cycle in which it's getting repayments. So its contribution has fallen back down to about where it was before 1983 and yet, it would take almost a tripling of the net disbursements from the World Bank to these countries to replace this reduction in IMF funding to them.

Part of the reason the World Bank got off to a slow start was the nature of its lending. It's a project lending institution, which means slow disbursements. It also has found that the policy condi-

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tions for its structural adjustment loans are difficult to negotiate. And it has also been the case that countries that are making sharp budgetary cutbacks don't have the resources to make even their local cost contributions to World Bank projects, and all of those factors have been responsible.

It does seem to me that it's time for the World Bank to move ahead aggressively and in a more active role. The first question, of course, is whether the World Bank has the resources to do that.

As you know, the World Bank's capital base is the ceiling on its outstanding loan potential. Its capital base now is $80 billion. It has about $42 billion of outstanding disbursed loans.

So it can lend in new disbursements the level of about $9 billion a year that is now envisioned in the Baker plan only for a few years. Within probably 3 or 4 years it will be running out of sufficient margin.

So it does seem to me that we have to be thinking about a fairly early World Bank capital increase.

In a Gramm-Rudman-Hollings environment one has to ask whether Congress will be prepared to go along with a capital increase. I would suggest one important approach which could help in Congress' willingness to do so, and that is to eliminate paid-in capital. Paid-in capital was already reduced from 10 percent to 7.5 percent of the capital authorization in 1980. There is no real reason why it couldn't be reduced to zero. And that, of course, would eliminate the immediate budgetary implications of increasing World Bank capital.

Let me turn to what no doubt will be one of the most controversial elements in the draft legislation before this subcommittee, and that is World Bank leveraging.

The idea is expressed in the draft legislation that the Bank could be leveraged at a ratio of 2 to 1 rather than 1 to 1, as is currently the case, although it makes the important qualification that somehow this will be introduced at the margin rather than for all outstanding capital.

It seems to me that the main reason to consider leveraging at all is the possibility that Congress will be willing to approve a substantially larger increase in the lending capacity of the World Bank through a combination of leveraging and increased capital than through increased capital alone.

Now one might ask, why would Congress care as between the two? Especially if there is no paid-in capital, there would be no direct budgetary implication of increasing capital. And so one could argue the cleanest way to increase the Bank's lending capacity is to simply have an outright capital increase.

It may be that Congress would nonetheless find that simply the authorization figures which must be included in expansion of the World Bank capital would inevitably enter into the budgetary debate, so that even though there were not paid-in capital, the approach of increasing capital would face serious obstacles.

If that is the case and if leveraging would not raise those same obstacles because it would not involve an authorization amount, then it is reasonable to consider the leveraging approach.

I would add perhaps a more profound reason for considering leveraging, and that is this. Since its inception, the World Bank has

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been a fully publicly guaranteed vehicle. Now one might view the historical process as shifting to a period in which it's more appropriate to share the risk with the private sector rather than to have a complete public guarantee.

Immediately after Bretton Woods, the World Bank was lending to war-torn economies, to very new developing countries, and complete guarantee seemed to be the only logical approach.

In the 1970's, we shifted, in some sense, to the opposite extreme, where private banks lent large amounts with no guarantee.

A swing of the pendulum back to a more balanced position between these two extremes might suggest that a relevant approach for the 1990's would be one in which the public guarantee would be leveraged in order to share the risk with the private sector.

For these two reasons, then, I think the subcommittee is to be commended for considering leveraging of the World Bank.

It must be said, however, that the mainstream opinion at this time seems to be that the dangers of leveraging for the World Bank itself are very substantial.

The first danger is the jeopardy to existing bondholders. One could argue that this jeopardy need not be great because the World Bank has a very good record of nondefault. And if capital covered only half of outstanding loans, it would still be very unlikely that the bondholders would be subjected to losses.

Nonetheless, it would probably be safer, as the draft legislation implies, to leverage at the margin so that the existing bondholders would not be jeopardized. And that would mean applying leveraging only to new bonds issued after 1986, for example.

One would have to combine that kind of leveraging with a capital increase because if you go through the numbers of it, if you have more leveraging but nothing new to leverage on, you can't get any results from it. But it would be possible to combine leveraging at the margin with a significant capital increase in order to get a substantial rise in Bank lending capacity.

Now even under this approach, many experts in this field are extremely concerned that leveraging will increase the cost of borrowing to the World Bank. To hear the people in the official circles tell it, the results could be truly drastic.

An informal poll of some very savvy participants in the financial markets who deal in these bonds might suggest that the results would be less devastating, that the World Bank might have to pay something like 30 to 50 basis points higher if it were leveraged at 150 or 200 percent. And one can perhaps gauge the magnitude of this by considering that the private commercial banks, which are leveraged about 15 or 20 to 1, seem to be paying about 100 basis points more than the World Bank for comparable maturities. And even allowing for the more risky country composition of the World Bank's portfolio, one might on the surface think that shifting the Bank to a reasonable leveraging ratio of 2 to 1 or so, or 1½ to 1 would not push the World Bank's borrowing costs above what the private commercial banks have to pay.

But there is, I think, a more bothersome consideration. Again, the experts point out that the bond market is inherently a market of very cautious investors. And for that reason, the market for AAA bonds is much deeper than the market for anything lower,

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AA, et cetera. And there's a significant possibility that shifting to leveraging would reduce the World Bank's credit rating from AAA to AA.

Now if it did so, even though the cost of the borrowing might not rise all that much in terms of basis points, the volume that the World Bank could mobilize might be significantly limited.

There is a certain theoretical base for this. The so-called theory of credit rationing says that credit markets do not necessarily clear simply by raising the interest rate. Intuitively, the reason is that if somebody is willing to pay you a very high interest rate, you may not want to lend to him because that may worry you about his riskiness, so that the market doesn't clear.

Well, that kind of approach would give some logical support to the idea that the World Bank might find it difficult to move the volume of lending that it would need to move if it adopted leveraging.

All of these considerations suggest to me that the decision on leveraging is extremely complicated and that the most prudent course at this time is probably to go for a traditional capital increase and not to raise these possible risks on the capital market by leveraging.

I would, nonetheless, suggest, and this is not in my written testimony, that the subcommittee might want to consider asking the Treasury to review the possibility of a new entity, a new affiliate of the World Bank which would be authorized to lend at a 2-to-1 leveraging ratio. It could be called, for example, the International Investment Corporation, because a totally different affiliate would not run the risk of killing the goose that laid the golden egg—namely, the World Bank, and of getting a perverse result of higher costs and lower volume.

And if, over time, this new affiliate showed that it was possible to tap the capital markets at relatively little additional cost, and yet, do so on a leveraged basis, then it might be desirable the next time around to focus any capital increase solely in that new affiliate.

My testimony touches on a number of other issues. I will try to be brief in summarizing them.

I suggest that World Bank guarantees of private loans, as in the case of Chile, where $150 million guarantee mobilized something over $1 billion of lending, are a useful vehicle for mobilizing capital and that those could be leveraged on a 2- or 3-to-1 basis without any adverse effects, rather than the very conservative 1-to-1 capital backing that they currently require.

On the disbursement issue, I suggest that the World Bank could take two or three measures to accelerate movement of funds to the borrowing countries. First, it could move more rapidly into program lending, structural adjustment loans, sector program loans, than it has done so far.

Structural adjustment lending is only 2 percent of lending and even including all forms of rapid disbursal lending, the amount is only something like 15 to 20 percent of the World Bank's lending process.

Second, the World Bank could liberalize its rules on how much its finance contributes relative to the local finance contributed by

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the country, because in an era of budgetary cutbacks in these countries, you get bottlenecks that inhibit the process of project disbursements.

The Bank already has some experience in its special action program in this regard and that could be stepped up substantially.

Finally, the float of about $15 billion that the World Bank has in liquid assets could in part be transferred to the central banks of the prospective borrowing countries in order to move the foreign exchange more rapidly.

It seems to me that these measures deserve serious consideration and I believe there is testimony from Pedro-Pablo Kuczynsk before this subcommittee that especially emphasizes the disbursement speed and the sharing of World Bank and local cost financing.

On trade liberalization, I would simply underscore the importance of the subcommittee's objective in trade liberalization. As we know, the countries in question must increase their exports if they are to come out of the debt problem. And yet, protection discriminates against exports. Protection gives an incentive to produce for the domestic market that equals the world price plus the tariff. Whereas, the incentive to produce for exports is solely equal to the world price, and this discrimination needs to be reduced if exports are to grow over time.

I do think that it's important that the language not be excessively rigid, that, for example, there not be a rigid trigger clause that suspends World Bank lending if such and such a country doesn't meet so and so liberalization target. We have to be realistic. The countries do not have the foreign exchange to suddenly finance a surge in imports.

So immediate liberalization would require more financing than they have.

It is also true that our appeal to their liberalization is a bit hollow in the face of some of our practices on protection in textiles, apparel, steel, sugar, et cetera.

Also, I think we have to be realistic not to expect a return of their trade deficits and current account deficits to the predebt crisis level.

In other words, they were overborrowing before the debt crisis and it is true that their deficits have gone down and correspondingly, our net exports have gone down. But that original position was not a viable position, so we shouldn't overstate the implications of how rapidly we could return to a significant net export position with them.

There are other considerations, including implications for sensitive industries. I won't go into detail.

The final segment of the draft legislation concerns regulatory treatment and secondary markets. A word on each.

I think it is timely to review these. I think we should not overstate their role in resolving the debt problem. Certainly that range of regulatory revisions which would be designed to paper over quasimoratoria, et cetera, I do not consider to be a mainstream solution to the debt problem, mainly because I think the bulk of the debt is owed by countries that are solvent and that should not resort to quasimoratorium solutions in their own interest, because if they do so, in the 1990's they will have a credit reputation that is

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damaged and that will adversely affect their long-term growth prospects.

I do think that there is a need for greater coordination between the policy level and the operational level in bank regulation. We have the policy level instructing banks to participate in new loan packages, but at the operational level, the bank examiners are telling banks that Mexico is a dangerous place to lend, Brazil, et cetera.

There needs to be a harmonization between those two levels.

Finally, on secondary markets, my view would be that the secondary market should be allowed to develop on its own, but not stimulated by government action. I think there is some danger in stimulation by government action because this is a distressed market that I think prices these assets at below their long-term real value and any enhancement of the prominence of this market that would be artificial would, I think, unnecessarily call into question the value of these claims on the books of the banks.

That being said, I see no reason to impede the secondary market insofar as it develops naturally in the private market because it does provide some additional liquidity to the system.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Cline follows:]

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Statement of
William R. Cline
Institute for International Economics
Before the US House of Representatives, Committee on Banking, Finance and Urban Affairs,
Subcommittee on International Development Institutions and Finance
March 12, 1986

Introduction

The international debt crisis has forced many developing countries to reduce their growth to achieve large and abrupt reductions in import expenditures. New lending by private banks has come to a near standstill. Active lending by the World Bank is essential to facilitate a return to growth and serve as a catalyst for renewed private lending. This statement considers the availability of World Bank resources to meet this task, and examines possible approaches to maximize these resources in an environment of extreme retrenchment in public expenditures. In addition, it examines briefly two other issues under consideration by the Committee: trade liberalization in developing countries, and the appropriateness of current regulatory treatment of private bank lending to developing countries.

Recent World Bank Lending

The World Bank's contribution to resolving the debt crisis has been more modest than might have been hoped. In 1983 to 1985 after the debt crisis began, net disbursements to the 15 countries in the Baker Plan averaged $2.8 billion, an increase by $1 billion over the corresponding annual average in 1980-82. Though sizeable in proportionate terms, this increase was limited relative to the size of the debt problem. In contrast, net

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financial flows from the IMF to these countries rose from $1.3 billion annual average in 1980-82 to a peak of $6.3 billion in 1983, and then ebbed to $3.4 billion in 1984 and only $1.7 billion in 1985. Net disbursements by the World Bank to these countries would have to rise by 160 percent just to replace the decline in the annual rate of net IMF lending since 1983.

Causes of the slow start in 1983-85 include the slow-disbursing project-loan nature of most Bank lending; difficulties in obtaining developing country agreement to the policy conditions placed on fast-disbursing Structural Adjustment Loans (SALs); and budgetary limitations on countries' contributions of local currency financing to projects. It is important to consider ways to overcome these limitations. First, however, it is necessary to consider the adequacy of World Bank resources for increased lending.

Capital Base

The World Bank's capital base is currently SDR 78.7 billion (roughly $80 billion). The base was last increased in 1980, from 40 billion SDR. By the Bank's articles of agreement, total outstanding loans cannot exceed capital. Total loans committed currently amount to $81.6 billion, but only $42 billion is actually disbursed and outstanding. Thus, the Bank has a capacity to increase its outstanding disbursed loans by about $40 billion. Its net disbursements were $5.3 billion in 1985, and the Baker Plan implies an increase in total net disbursements to the range of $8-9 billion annually. At this rate the World Bank would run out of funds for new lending within 4 to 5 years, and

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sooner if it left some cushion in its accounts.

The most direct way to increase World Bank lending capacity is to increase the capital base. At the 1985 annual meetings in Seoul, several countries proposed substantial increases in the capital base, in the range of 50 percent. The United States opposed a capital increase at this time, but implied that if the World Bank, the debtor countries, and the private banks effectively implemented the "Baker Plan" for dealing with the debt problem, future increases in the World Bank's capital would receive U.S. support.

A 50 percent increase would bring World Bank capital to approximately $120 billion. At this level, annual net disbursements could be sustained at a rate of $9 billion for nearly a decade before requiring new capital, or--more appropriately--could rise at least to keep pace with world inflation but require further new capital perhaps two to three years earlier.

In terms of domestic U.S. politics, the environment of sharp budgetary cuts will make a capital increase even more difficult than in the past. However, it should be possible to formulate the mechanics of the next capital increase so that there is a minimal or zero amount of actually paid-in capital. The fraction paid in was already decreased from 10 percent to 7.5 percent in the 1980 capital expansion. With the entire amount of new capital callable and none paid in, there would be no direct budgetary implications of increasing the Bank's capital base. The absence of paid-in capital could thus help achieve

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Congressional passage of a capital increase. Note that the U.S. Export-Import Bank is already on a basis of virtual absence of direct budget appropriations, because its program is based on loan guarantees. U.S. capital for the World Bank is essentially a guarantee of international agency lending, and an increase in this guarantee authority with no corresponding paid-in item in the budget would be consistent with EXIM treatment.

Leveraging

It has often been suggested that the World Bank could increase its lending capacity by changing its Articles of Agreement to permit a higher gearing ratio of loans to capital, at perhaps 150 percent to 200 percent. There are important arguments both for and against changing the gearing ratio.

The principal question is whether Congress would be willing to authorize a substantially larger World Bank lending capacity through a combination of increased leveraging and additional capital than through increased capital alone. If not, the cleanest approach would be to remain with 100 percent gearing and simply increase the capital base. Conceivably Congress would be more willing to provide larger amounts of lending capacity than otherwise by increasing leveraging. Capital increases must be authorized even if there is no paid-in capital, and they therefore inevitably enter the budgetary debate. Increased leveraging would not require an authorization (because technically it would not increase contingent U.S. obligations but instead would be achieved through a renegotiation of the articles of agreement.

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In one sense the most profound issue concerning leveraging is one that has received little attention. A substantial increase in the gearing ratio would turn the World Bank into an instrument that shares risk with the private market, rather than one that acts as a vehicle with full public guarantee. Historically a complete guarantee was essential at the time of Bretton Woods, when war-torn economies and developing countries were not creditworthy. By the 1970s and early 1980s the situation had changed so much that private lending to developing countries took place in massive (and excessive) volumes without any guarantee. After the debt crisis this lending dried up for several major debtors. Nonetheless, the longer-term creditworthiness of many of these countries, and certainly of other newly industrialized countries that have escaped the debt crisis, remains stronger than originally envisioned at Bretton Woods. A partial swing of the pendulum back toward more balanced private and public lending might indeed suggest the appropriateness of a leveraged World Bank that shares the risk with the private sector.

The arguments against increased leveraging warrant careful consideration, however.

One major argument is that a shift to a higher gearing ratio would prejudice existing bondholders, and might even cause bondholder suits. Considering that the World Bank's loan experience is extremely favorable, the potential damage to bondholders from a higher gearing ratio would seem small; for example, more than half of loans would have to be in default for

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bondholders to begin to experience losses under a 2 to 1 gearing ratio, yet the Bank's record is virtually free of defaults. Nonetheless, it might be prudent to avoid the problem of existing bondholder rights by leveraging "at the margin." Thus, new bonds issued after a specified date would be in a separately identified New Series that would contain explicit language on the new gearing ratio. If necessary, the new bonds could be subordinated to previous bonds. Leveraging at the margin would have to be combined with some increase in the capital base, however; otherwise the increase in the lending capacity would be limited.[1]

The second traditional argument against a higher gearing ratio is that it would raise the World Bank's borrowing costs. Although some market participants fear substantial increases in borrowing costs, others view the World Bank's record as sufficiently conservative and prudent that, even with the gearing ratio increased to 150 or 200 percent, the Bank's borrowing costs might rise by a tolerable amount -- perhaps in the range of 30 to 50 basis points. It is of interest that some large, private international banks appear to be paying about one percentage point higher than the World Bank for comparable maturities.[2] Yet

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[1] World Bank bonds outstanding amount to $46 billion. The Bank can thus borrow about $34 billion more before reaching its capital ceiling (although technically the gearing ratio applies to loans, not borrowings). At 150 percent leveraging on this "margin" of new borrowing, lending capacity of $51 billion would be mobilized -- an increment of $17 billion beyond the amount possible without leveraging. In contrast, leveraging the entire existing capital at 150 percent would bring lending capacity to $120 billion, an increment of $40 billion. To achieve an increase of this size, 150 percent leveraging at the margin would have to be combined with a capital increase of $15 billion (approximately 20 percent).

[2] On February 13, 1986, fixed-rate bonds of Citibank and

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commercial banks have loan to capital leverage of approximately 15 or 20 to 1. On the surface it would seem unlikely that the World Bank's borrowing costs would rise by more than the 100 basis point differential relative to these private banks if the World Bank shifted to 150 percent or 200 percent gearing, even allowing for the more risky country portfolio of the World Bank.

If borrowing costs rose by 100 basis points or less but the total loan volume mobilized by the World Bank rose substantially, the trade-off could be desirable. The opportunity cost of scarce foreign funds can often reach ranges of 20 percent or higher in developing countries, and an increase of one percentage point or less in the cost of borrowing from the World Bank might be willingly paid by many countries if it would make possible major increases in the volumes of World Bank funds available to them.

The most serious drawback of the leveraging approach may thus be the risk that it could actually jeopardize large volume movements in World Bank borrowing and lending. The World Bank is the world's largest borrowing entitity. It enjoys a triple-A rating. If leveraging reduced the rating to double-A, then even though the increased basis points the Bank would have to pay might be tolerable, it could prove difficult to move the large volumes of lending that are involved, because the double-A market is reportedly considerably thinner than the triple-A market. The theory of credit rationing recognizes that borrowing is a process

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Manufacturers Hanover traded at 10 percent yield for maturities of 2000-2007, versus 9.77 percent for the World Bank, while maturities in the early 1990s traded at 11 percent and 8.9 percent, respectively. Wall Street Journal, Feb. 14, 1986.

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in which the market does not necessarily clear merely by raising the price -- the interest rate -- because the fact that the borrower is willing to pay a higher rate is a signal to the lender that the loan is more risky.

These are questions of market institutions and reaction that would have to be carefully considered before moving to leveraging. I suspect that the market reactions to leveraging would be less cataclysmic than the standard views in official circles would imply, however. I would also suggest it is time to reconsider whether the World Bank should be opened up to risk sharing with the private market, although even in this dimension there are major implications (such as the possible shift in World Bank priorities toward more conservative lending policies and behavior less oriented toward the public good) that would have to be considered.

At the present time the most prudent course would probably be to retain the gearing ratio at 1 to 1, and to seek expansion in the World Bank's lending capacity through a normal capital increase. This course may impose more of a burden on the supporters of the World Bank in Congress, but it should be possible to make the case that despite authorization figures for capital increases, there is little or no real budgetary impact -- not only because paid-in capital can be avoided but also because the true probability of default is so small that the capital is unlikely ever to be called.

Loan Guarantees

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A promising avenue for indirect leveraging would be the expanded use of World Bank loan guarantees on a leveraged basis. In the past, guarantees have been treated as requiring the same 100 percent backing by capital as direct loans. Not surprisingly, under past practice the Bank has made only modest use of the guarantee mechanism, considering that the resource constraint is the same as for direct loans. However, it would be possible to change administrative practice to require perhaps only 25 to 33 percent capital backing for loan guarantees. The record of low defaults on World Bank loans could provide a basis for fractional backing of guaranteed loans. Importantly, the use of loan guarantees in conjunction with broader packages of private bank lending could serve as a catalyst to mobilize private sector finance. In the Chilean case in 1985, the provision of approximately $150 million in World Bank guarantees was critical to the mounting of a package of over $1 billion in new money.

Flow Management

The final area of World Bank resource mobilization concerns the use of existing resources over time, or flow management. If the scarcity of foreign exchange is extremely nigh at the present time but is expected to moderate as the country expands export production in the future, reallocation of disbursements from the future to the present may be desirable.

One area of flow management concerns the choice of program versus project lending. Project loans are inherently slow in disbursement, given their link to physical completion of

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projects, while program loans can be disbursed rapidly. World Bank program lending has taken the form of Structural Adjustment Loans (SALs) at the macro level, as well as sector lending with policy conditions at the sectoral level. In 1985 SALs narrowly defined accounted for only 2 percent of Bank lending (commitments). Including "sector adjustment loans," adjustment lending amounted to 9 percent of lending, and including all other forms of rapid-disbursal lending this share rises to approximately 15 to 20 percent. The World Bank could move much more rapidly into SAL and sector adjustment lending to accelerate loan disbursement.

Conditionality of SAL loans is an area that will require further learning on both sides. The policy goals of the Baker Plan--trade liberalization, investment liberalization, and reduction of the state sector--should be pursued flexibly and with realistic time horizons, and coordinated with key macro policy goals: realistic exchange rates, positive real interest rates, and satisfactory fiscal and monetary policies. It would be a mistake to make SAL conditions (and their overlap with IMF conditions) so stringent that countries are unwilling to enter into these loans; it would also be a mistake to disburse SAL money with virtually no meaningful policy conditions. It may be necessary to restructure World Bank staff organization to develop proper country policy design and monitoring. The Bank has been essentially a project-oriented institution until now.

In addition to shifting from project to program lending, changes in the required portion of local-currency financing can

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help expedite disbursement. A problem in the period 1983-85 has been that as debtor countries have cut back fiscal budgets to comply with IMF adjustment programs, they have been forced to reduce local currency expenditures on some World Bank projects, thereby delaying progress of these projects and their disbursements. The World Bank could adopt a policy permitting foreign-exchange financing of a larger portion of local currency expenses. This change could be made both by currently financing a larger portion by foreign exchange in return for higher local-currency financing later in the project (essentially, anticipated disbursement), and by permitting a permanent rise in the fraction of project costs subject to foreign exchange financing.

Disposition of the World Bank's financial float is a third area of flow management. Because of the lag of disbursements behind commitments, associated with the long time horizons of project construction, the World Bank has a "float" of over $15 billion in funds that it has borrowed from financial markets as a prudent reserve against commitments but that it has not yet disbursed. Lessard and Williamson (1985) have recommended that some portion of this float be turned over immediately to the central banks of borrowing countries (presumably only in cases where the current scarcity of foreign exchange is seen as being more severe than expected in future years). The country could use the earmarked World Bank commitments for short term foreign exchange needs, and subsequently finance the foreign exchange requirements of projects out of its own earnings or private foreign finance.

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Trade Liberalization

Draft legislation before this committee emphasizes trade liberalization within developing countries. This objective is important because lower protection in these countries is essential to the long-run development of their export and debt-servicing capacity. Firms in these countries face an incentive to produce for the domestic market equal to the world price plus protection, whereas their incentive to produce for export equals only the world price. Lower protection will shift resources toward the export sector.

Trade liberalization is also important for the perception of fairness in world trade. The U.S. Congress has a right to seek open markets abroad. Many of the newly industrialized countries are sufficiently formidable competitors in manufactured goods that it is outdated to insist that they enjoy total non-reciprocity -- absence of any commitment to carry out liberalization of their own despite substantial past liberalization of industrial country markets.

It would be a mistake, however, to impose a severe rigidity on the World Bank in its pursuit of the objective of trade liberalization. In practical terms, many of the debtor countries simply cannot reduce barriers overnight because they do not have the foreign exchange to pay for the additional imports that would result. Abrupt liberalization would mean much larger financing needs, and financing availability is already hard pressed. Moreover, intellectual candor requires recognition that insistent

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demands by the industrial countries for "reciprocity" from developing countries ring hollow in the face of massive tariff and non-tariff protection against some of their most important exports: textiles, apparel, steel, footwear, and others. And again, intellectual candor requires recognition that if the developing countries do liberalize their import markets, the result will not be a net increase in the U.S. trade balance with them, but a maintenance of that balance through a parallel rise in both U.S. exports to and imports from these countries. Congress might pause in insisting on immediate implementation of this program if it considered that the likely products on the list of additional imports from the debtor countries would include several that would be considered already sensitive to import pressure within the United States.

For these reasons I would find it counterproductive to incorporate legislative language that ties the World Bank's hands in lending with regard to the speed and extent of trade liberalization required of World Bank borrowers. Congressional intent should be limited to broad guidance, rather than pushed to the point of attempting to use the World Bank as a club to obtain immediate action on sore spots in the trade horizon. Thus, I would find it counterproductive to force a World Bank suspension of lending to Brazil (for example) if it did not immediately meet some targeted liberalization. Instead, the framework of lending should be oriented toward trade liberalization over time, including through the country's participation in multilateral trade negotiations that can provide it with corresponding

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negotiated liberalization in industrial country markets.

Financial System Stability

Finally, the draft legislation before this committee proposes a review of regulatory treatment of foreign lending, secondary markets for such lending, and possible new instruments to mobilize further lending. Such a review would be timely. However, it is important to recognize that there are limits to the contribution some of these approaches can make.

One viewpoint might be that the debt problem should be handled by liberalizing regulation -- authorizing multi-year write-offs, treating capitalized interest as accruable into current income and not requiring loan loss reserves, and so forth. There may be room for some of these measures in extreme cases. However, the bulk of the debt is owed by countries that should be able to avoid these more extreme solutions. The crucial point to recognize is that countries that must resort to such measures tend to do damage to their own future development by spoiling their credit ratings for the 1990s. (Note however that under some circumstances mutually agreed interest capitalization might be a contingency option that would do relatively less damage to future creditworthiness.) The broad thrust of public policy should not be to push countries into such solutions when they can avoid them.

The more germane regulatory problem today is the lack of coordination between the policy level and the operational level. At the policy level, the Federal Reserve and Treasury typically encourage new bank lending as part of a package that

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includes an IMF adjustment program and official lending. Unfortunately, it appears that at the operational level, bank examiners often indicate to banks that further exposure in these countries would be risky. Coherence between the policy and operational levels is needed.

As for secondary markets in developing country debt, it would seem that the private market should be left to develop this market without public assistance. To some extent this is a distressed market and prices probably understate the long-term value of debtor country obligations. Overstating the prominence of this market by giving it some form of official enhancement could tend to undermine confidence in the existing claims of private banks on the debtor countries, and even change the regulatory climate in a direction forcing "mark to market" treatment in an unfavorable environment (and in contrast to treatment of domestic claims which are held at book value until maturity or exchange). At the same time, if the private market can provide more liquidity and flexibility by developing secondary marketing of these assets, the government should not stop it from doing so.

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Chairman LUNDINE. Thank you, Mr. Cline. Mr. Sewell.

STATEMENT OF JOHN SEWELL, PRESIDENT, OVERSEAS DEVELOPMENT COUNCIL

Mr. SEWELL. Thank you, Mr. Chairman.

I want to commend you and Congressman Bereuter for taking the lead on these issues because they are very important to a wide range of U.S. interests.

I don't have a written statement, as you know. I would be happy to give you comments afterward on the legislation.

Chairman LUNDINE. Without objection, your later written statement when received will be made a part of the record. I appreciate your testifying on rather short notice.

Mr. SEWELL. I am more than glad to do it.

I brought with me two briefing papers produced by the Overseas Development Council. One is on trends in the U.S. Aid Program and the other is on the U.S. trade deficit with the Third World. I am happy to make them available to the subcommittee.

Much of what I am about to say is drawn from a series of recent ODC studies, but particularly, from a forthcoming volume which will be out in June, entitled, "Between Two Worlds—the World Bank in the 1990s." This policy study analyzes some of the issues that we will be discussing.

My comments, however, are my own and do not necessarily reflect the views of the ODC staff or its board.

There is now clear agreement that the World Bank must take the key leadership role in the late 1980's and 1990's in dealing with the ongoing global economic crisis. And by that I mean both the debt crisis and the closely related trade crisis.

But having said that, as the Baker initiative did in a very welcome fashion, raises as many questions as it answers. Let me raise a few of those in my presentation.

The first concerns the Bank's role in policy-based lending.

Second, on how the Bank is financed in the future.

Third, the Bank's role in addressing global poverty.

And fourth, the U.S. interest in dealing with these issues, at a time when budgetary resources are very constrained and the question of what we can "afford" or not afford is a very real one.

Let me take up the first issue very briefly—the Bank's enhanced role in policy-based lending, whether it's—technically—in terms of the structural adjustment loans or sectoral adjustment loans.

This issue needs careful analytical examination, which has not yet been undertaken, either on the outside or within the Bank.

On the one hand, of course, the Bank's role in pressing for changed policies by developing country governments is not new. The Bank has been doing this for a long time, particularly on a sectoral basis, in various countries.

But in recent years, both structural adjustment loans—the so-called SAL's—and the sectoral adjustment loans, have received increasing emphasis.

Now, this is a move in the right direction. If we've learned anything from the 1970's, it's that traditional development projects, that the Bank finances or which are financed by other donors, are

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not going to succeed in an environment of slow growth and bad policies.

But there's an easy assumption behind all of this that with policy-based lending and conditionality, tied to long-term growth objectives and long-term development objectives rather than short-term stabilization, it is easy. It's not.

In fact, it's extremely difficult and one has to be very careful in talking about policy-based lending not to raise false expectations either about the nature of the changes or the period in which we're going to see results. Policy change is a very long-term process which is going to require the Bank to operate in a very different way.

The record of the last 4 or 5 years demonstrates the problems. As Bill Cline said, the number of structural adjustment loans as a percentage of the Bank's total lending is still very small. And even if you add the sectoral adjustment loans, the percentage is not that much greater. They have been slow to expand because they're very difficult and they're politically contentious.

Even many of the IMF programs that have much shorter terms and, in a sense, much more clear-cut objectives, have failed to achieve all of their objectives. The landscape is littered with failed and abandoned IMF and World Bank programs.

I would like to reiterate that this is the right direction in which to move. But also to underline how difficult it is. There is, of course, much agreement on what sound economic policies or correct economic policies would include as a framework for structural adjustment and development, whether defined in terms of trade balances, exchange rates, et cetera, et cetera, et cetera. But there's a great lack of knowledge of how those policies should be implemented and how countries move from a situation of unwise policies to wise policies and over what period of time.

The key problem, of course, is as much political as economic, because when one talks about policy-based lending, one moves quickly from the standard issues of adjustment in the terms that the IMF uses it, into issues of what are known in my field as development strategies—that is, the choices by countries and governments about what kind of economic, political, and social future they want.

As a result you very quickly get into quite legitimate disagreement over a whole range of very contentious issues. What is the role of the state in economic activity? What are proper choices about income distribution and equity? The benefits or the costs of export orientation? These are very difficult issues that are at the heart of most countries' national sovereignty, and they're not going to be resolved very easily or very quickly.

The institutional and political implications for the Bank, by the way, are quite considerable. Does the Bank have the right staff? It's current staff is very good at project lending and economic and financial analysis. But the Baker initiative asks the Bank to assume a diplomatic role which is quite considerable.

As a result, you run the risk of putting the Bank in the position, that the IMF is in now—that is, it's practically persona non grata in large parts of the Third World.

And the issue is raised, of course, of whether the Bank would have sufficient resources to play this new role. There's nothing

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worse than urging policy reform without sufficient and assured finance so that political leaders can make difficult choices.

And finally, the issue arises of the Bank's relationship to the International Monetary Fund and its more traditional short-term balance-of-payments financing role?

The second set of concerns involve how the Bank is to be financed. I don't want to repeat what William Cline said in his very excellent testimony. There is no question, it seems to me, that additional resources for development are needed and that they're going to have to come from the World Bank or through some other public sector institution. In the next 5 years, at least, private flows are going to be very constrained.

I don't think anybody will say that private bank lending is going to increase very greatly in the next 2- to 5-year period of time.

Similarly, a forthcoming ODC analysis, entitled "Between Two Worlds: The World Bank in the Coming Decade," concludes that private equity investment is not going to increase very greatly in the next 3 to 5 years, at least for good parts of the Third World.

The Bank needs more resources because money is the essential lubricant for the kind of policy leverage envisioned in the Baker initiative.

For the World Bank itself, there are really only two choices—a general capital increase of requisite size, or change in the gearing ratio.

My own feeling is that a general capital increase is preferable as long as it's politically possible because it will have no impact on the credit rating of the Bank itself, and that's important to preserve.

I don't see why that can't be done with no paid-in capital at all, unless there are political problems from the standpoint of the congressional budget process.

If that's not politically possible, of course, leveraging, or changing the gearing ratio, becomes that much more attractive, particularly if it has less of an impact on the Gramm-Rudman-Hollings calculations.

It seems to me that careful work is needed by the Treasury or others on the questions that were raised in Bill Cline's testimony. If one can leverage a great deal more money at relatively little cost, whether the extra cost of the money is borne by the Bank or borne by the borrowing countries, or some combination of both, then changing the gearing ratio becomes an attractive proposition. I would hope you would press that question very closely on the commercial bankers and bond buyers when they testify before the subcommittee.

For the International Development Association—the "soft loan" window of the Bank—the issues are much more complex because the budgetary costs are not small. IDA-VII, is much lower than IDA-VI, at $9 billion. If I understand the state of negotiations over IDA-VIII correctly, it will be back to the level in nominal terms of IDA-VI, about $12 billion.

My strong preference, is for an adequate IDA-VIII commensurate with the needs of the IDA countries, which is probably somewhere around $15 billion or $16 billion. I don't have to vote on

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budgets and that's easy for me to say. But I think two points need underlining.

First, for sub-Saharan Africa the needs are great. In the area of policy reform, the world is winning in sub-Saharan Africa. African governments are now quite willing to take the very tough choices implied in policy dialogue and policy change, but they'll need financing on very concessional terms to do it.

And, of course, India and China, which are two huge giants still in terms of the size of their economies and their populations, still remain, at least for the period of time of IDA-VIII, in the category of needing concessional resources.

Any other solution to IDA is second best. You can reduce the size of IDA and reduce the number of countries that have access to its resources. In effect, India and China would be out of IDA-VIII or fewer resources would be spread too thinly.

There are also a number of proposals floating around for using some of those IDA funds to subsidize interest rates for the countries that are somewhere between the very low-income countries and those no longer eligible for IDA. Again, the key issue here is where you count India and China as the big claimants in IDA funding.

Funding IDA-VIII adequately is an extraordinarily tough issue when one looks at the budgetary constraints which are going to be faced by almost every major donor in the OECD countries.

Let me then turn briefly to the role of the Bank in the direct address of poverty.

It's worth remembering, I think, in this very very important discussion of debt issues and trade deficits that the ultimate gool of development is to allow people to improve their own well-being. Economic growth is really only a means to that end.

How do you help people become measurably better off, whether you're using economic, social, political, or even cultural criteria for what "better off" means?

The current focus on adjustment and on economic efficiency in the Bank and in general has obscured the concern with the direct address of poverty. You can see it in the rhetoric of the Bank; you can see it in its research program; you can see it in the fact that the Bank no longer produces figures on how many people are living in absolute poverty; you can see it in the fact that no one can tell you whether people in the Third World are better or worse off in 1986 than they were in 1978.

These are very important issues for the 1990's, when one looks at the future of the World Bank. The Bank, of course, is still funding a fair amount of projects in social sectors, probably at the same level that it did in the past. But I believe that it has a major role to play in the 1990's, especially in looking at how to markedly improve human well-being at a much lower cost.

We do not have time to go into these issues here. But it's clear that we can't provide health care in the developing countries as we do in the United States or Europe; and we can t provide education in the same way because the resources are just not going to be there.

If people in the Third World are going to have access to adequate health care, we are going to have to look for different ways of de-

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livering health care, particularly to rural populations; different ways of delivering family planning services, and so on.

The Bank, with its experience in this field, and with its superb research capability, could have a major role to play in this area.

Let me turn quickly to the issue of the United States self-interest in these issues. At a time when we are pressed from all sides for defense, domestic, and social spending, and so on, why should we pay much attention to what the Bank and IDA do?

Let me just make a few points.

I think it's important for Americans to realize that economic growth in the Third World is no longer a matter of altruism or even of fighting communism. The Third World, in the aggregate and in many cases in terms of individual countries, is now a major participant in the international economy.

A few years ago, the OECD did a major study of global economic growth in the 1970's. The top 40 developing countries—those which grew the fastest during the period 1970 to 1979—added as much, to the increment of global growth as did the United States, or Germany, and Japan combined.

Now whether you look at trade, where 10 of our top 20 trading partners are Third World countries; whether you look at their participation in the international financial system; whether you look in terms of U.S. direct investment, these clearly are no longer issues of altruism, but, rather, direct U.S. self-interest.

Next week, one of my colleagues will be testifying before this subcommittee on the results of an ODC study which we call the Costs of Recession. When you analyze what has happened to U.S. trade with the Third World since 1980 as a result of global recession, you find that 43 percent of the trade deficit of the United States is due to reduced trade with the developing countries.

If you use the standard equation of exports to American jobs, there were 560,000 fewer jobs in 1984 than there were in 1980 due to the decline in U.S. exports to the developing countries. Somewhere around 8 percent, on the average, of U.S. unemployment over those 4 years was due to that drop in exports to the Third World.

So there's no question that growth in the Third World affects our economic interests. The question of the future of the World Bank and its central role in reestablishing economic growth in the Third World is very much in our interest.

Finally, let me talk about what the United States can afford in this field because there's a pervasive feeling in this country, and certainly in Congress, that we can't afford to support both our economic, political, and social interests in the Third World, as well as our military and security interests.

It is worth noting for the record that foreign aid, as set fourth in section 150 of the Federal budget has risen dramatically. In fact, it has increased 50 percent, from $9.7 billion in fiscal year 1980 to the proposed level of $16.4 billion in 1987.

It is hard to argue that funds are not available to meet U.S. interests in the Third World when we look at the percentage of aid increase over those several fiscal years.

The real issue is what are they spent for. As most people in this room know, foreign aid funds go primarily for military security

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programs and for short-term political programs. Military aid and Economic Support Funds, now account for over two-thirds of the total aid program. As a consequence, the contribution to development aid has become a much smaller percentage of the budget.

You can see this most directly in the deemphasis on multilateral assistance, which has dropped from 44 percent to 27 percent of the total budget for foreign aid.

To close, I would argue that U.S. leadership on these issues is crucial and that's why the subcommittee's discussions and proposals are particularly important.

Whether we like it or not, in the period ahead, not much is going to happen unless the United States takes the lead.

Therefore, the Baker initiative is particularly welcome. And one would hope that its implementation, which also is very important, goes very quickly, including the confirmation of a new president of the World Bank.

However, I think the administration needs encouragement, if I can put it that way, in a variety of ways to push ahead on these issues. And here, Congress has a major role to play.

There is a strong belief, at least on the other end of Pennsylvania Avenue, that Congress is the problem and that somehow or another, one cannot ask for or make arguments for additional resources in new programs because Congress will not provide them.

I don't think that is always the case; and I say this without in any way downplaying the problems of the budget, particularly in the next 6 to 8 months. But I think the record shows that Congress has indicated that it is willing to support more forthcoming policies, through particularly for the World Bank, whether it was the initial discussions about the level of IDA-VII or the congressional willingness to provide money for the Bank's African Special Fund.

I think that the leadership you have taken on these issues and these hearings are therefore very important. I will be happy to answer your questions.

Chairman LUNDINE. Thank you.

Ms. Lissakers.

STATEMENT OF KARIN LISSAKERS, FORMER DEPUTY DIRECTOR, STATE DEPARTMENT POLICY PLANNING STAFF

Ms. LISSAKERS. Thank you, Mr. Chairman. I will also summarize my remarks.

Chairman LUNDINE. Thank you.

Ms. LISSAKERS. The legislation that you put forward I think quite rightly recognizes that the first stage of the debt crisis—that is, the process of forced lending by banks and emergency loans from official sources to enable countries to barely maintain interest payments on the commercial debt—has run its course. It's run its course because the banks don't want to play the game any more and increasingly, the debtors don't want to, either. A different approach is required.

That different approach, as your legislation also recognizes, has to move on two fronts. One, the official lending front, and the other, through the private financial markets. And I think it's very important to keep these two separate. While I fully subscribe to the

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notion that the World Bank and the other official lending institutions can and should do more and make more resources available to these countries, it's a mistake to think that the World Bank is going to solve the commercial debt problem. The commercial debt problem has to be solved by the financial markets, if for no other reason than it is so enormous that the resources of the World Bank are not now and will not be large enough to solve it and it would be a diversion of what those institutions are meant to do to put them in that posture.

The $15 billion or so that the World Bank is able to lend per year now to spread over 100 or so countries doesn't even cover 1 year's interest payments by Mexico and Brazil.

So I think it is important to keep the two separate. They are not unrelated. But they have different purposes in this situation.

I think you need three broad steps.

The stated goal of the Baker initiative, of your legislation, of the World Bank, of everyone, is to get a resumption of healthy economic growth and activity in the developing countries. That is the primary objective. I think you need three steps to get there. Two of them will fall heavily on the private sector creditors.

One step is to give immediate relief on interest payments. I disagree with Bill Cline on this point, and let me explain why I think that's now necessary.

The basic bargain struck between the commercial banks and the debtor countries after 1982 was you, the debtor, maintain interest payments on the commercial debt to the banks in return for emergency lending, forced lending, and, and this is crucial, the promise of future access, normal access, to credit. That was the deal.

The unstated assumption was the resumption of normal lending would take place before the debtor countries had run out of tolerance for the economic hardships and the political difficulties they were going through in maintaining interest payments without normal access to the credit market.

Now it's sinking in on the debtor countries, and I think the bankers are facing up to it, too, that the resumption of normal lending isn't going to happen any time soon. And the debtors are now saying, and I think that's what's happened with Mexico, when Tella Madrid says, we don't want more loans. We want interest relief, or at least that's part of the package, because if you talk—I spend a lot of time talking to commercial bankers. There are still some very large U.S. banks who are so deeply into these countries that they, I think, feel they will lend at the barges. They will lend the bare minimum necessary to keep a Mexico or Brazil afloat.

But if you talk to the German banks or to the French banks or the British banks or a lot of regional banks in the United States who have written down these loans or accepted the fact that they are not going to be repaid, they don't want to commit more resources. The German banks, I have been told, have written off 75 percent of their Latin American exposure.

Now if there's a major political effort to lean on them, they might put up more resources. But the attitude is very, very negative. And if there would be more lending, it would be small and it would be forced. It would not be a resumption of normal lending.

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The level of money that you are going to squeeze out is simply going to be enough to perpetuate the situation which you have now where the countries, yes, maybe maintain interest payments, but will they grow? No. Will they open their markets to imports from the United States and other industrial countries? No. They will continue—you will have a perpetuation of a situation where these countries have their economic backs against the walls continuously. That means that's bad for our economic interest and it means that you are not really going to get the kinds of dramatic economic reforms that we're talking about in these countries because there's no breathing space for them to undertake reforms.

So that I think the key is to first give immediate relief on the interest payments. That is also from our budgetary standpoint the most efficient way to do it. And from the long-term viability for these economies, it's the way of giving them resources to work with without increasing their external debt, which is already too large.

There's a very good reason why the commercial banks do not want to lend more money to these countries—they are not creditworthy. And I think as long as you have this mound of debt overhanging those economies, they will continue not to be viewed as creditworthy.

Now you can talk—obviously, there are differences between a Brazil and a Mexico. But even when you have an improvement now in both the interest outlook and some good prospects perhaps for more rapid economic growth in Europe and Japan because of the fall in oil prices, the fact is that these countries will constantly remain vulnerable to adverse turns in the interest rate environment or the growth rate in the industrial countries.

So that their prospects may look good for the moment, for the next 6 months, the next year, but the moment you have another downturn, you are right back in the soup again because the debt is so large and because of the resources they're having to put into interest payments which don't go for growth or for investment.

If you look at the investment picture, in Latin America, for example, it has been devastating the last 3 years. That means in some ways they are less creditworthy now than they were even 3 years ago.

I don't think you would require major—you have raised the question in your material about regulatory changes. As far as I have been able to understand from the accounts, no major regulatory changes would be required to permit the banks to lower their interest rates. They could, in fact, maintain the same loan on their books and simply reduce the interest charges on it and it wouldn't even be required to write down the asset. Or you could have a conversion of the asset, which I will get to in a minute.

I think the regulatory obstacles in general by the banks have been exaggerated partly deliberately by the banks to give them an excuse not to do what they don't want to do, anything that would involve some cost to themselves.

In fact, the regulators have, if anything, been too flexible in letting the banks carry a lot of questionable loans on their books at full face value. And the testimony yesterday by the regulators on the farm loans indicated there's a lot of regulatory flexibility, even

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under existing legislation. I don't think legislative action is required on this front.

I think interest relief is only a first step. The second is to reduce this overhang of commercial bank debt, because if you don't break up that logjam of existing debt, you're not going to get down the road a resumed flow of private credit, whether it's from the banks or from direct investment, multinationals or portfolio investment.

I mean, direct investment in Latin America has dried up along with bank lending in this last 3 years. And I think as long as one sees this mountain of debt out there, private investors and commercial banks are going to be very reluctant to commit new resources because the growth prospects for these countries are not very good.

The other problem, and this is directly relevant to your consideration of the World Bank, that the outstanding debt is also an obstacle to additional lending by the official institutions. In fact, it's the incipient countries that lack the budgetary resources to fulfill the counterpart requirements. And even if they have the counterpart fund requirement to complete a specific project, the fact is those governments are unwilling to undertake a project that would involve future government expenditure, whether it's for salaries for teachers or doctors in hospitals or maintenance of highways that may be built. And the World Bank and the IDB and so on don't generally cover operating costs once a project is completed.

One reason they have such enormous budgetary constraint is that a large part of the foreign debt, an increasingly large part of the foreign debt is public sector rather than private sector debt in these countries. It's not just because the government did a lot of the original borrowing and have been the main recipients of the forced lending over the last 3 years. But there's been another process that works that I think has been very damaging. And that is that the commercial banks have forced the governments in these countries to assume the foreign debt obligations of failing private sector entities—banks and other companies.

The foreign banks have said, in effect, to Mexico and so on, when we lend to your private sector, we don't recognize our commercial credit, any commercial credit risk. If this company goes bust, for whatever reason, whether because of devaluation or some other reason, or the managers take the money and run, as has happened in the Philippines, you, government, are obliged to assume the foreign debt obligation of this private company.

If you look at the numbers in the Philippines, for example, the public sector share of United States bank claims on that country has risen from 39 percent in December of 1981 to 61 percent of the total outstanding debt by September of last year.

There hasn't been much addition to the Philippine external debt. Stated another way, while the total Philippine debt to the United States banks rose by only 2 percent in this period, the public sector's debt to United States banks increased by 59 percent. And that's partly because of this forced takeover.

I asked the head of the central bank sometime ago, Jose Fernandez, about it, and she said, admitted that it was part of the deal, the debt restructuring deal with the foreign banks that the banks

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be given the option of converting commercial debt, including claims on failed Philippine banks to public sector debt.

That was part of the negotiations I didn't like, he said, but I had no choice. And the same thing has been true in other places in Latin America and the numbers reflect it, where you see an enormous increase in the public sector debt of Brazil, Mexico, et cetera.

So you have a fantastic fiscal crisis in these countries. At the same time that the IMF and we and other creditors are pressing them to reduce the public sector share of the economy as a whole, you have a situation where 35 or 40 percent of total government expenditure is going to service domestic and external debt, at a time when government revenues are obviously falling because their economy has been depressed.

So there's a tremendous trap, even if you see, and this is true even in Brazil, even though you see an improvement on the external accounts. The internal accounts are not very healthy, and that's another part of the external debt problem.

But I think we have reached the point where one has to start thinking seriously out a forced write-down of the existing body of debt, whether it's a flat write-down of some percent of the debt or a substitution of equity for debt-to-state enterprises; for example, which banks would be allowed to do. While there's a limit on how much equity banks are allowed to hold in a private corporation, there is considerable leeway when you're in the middle of a troubled debt restructuring. Banks have been allowed to hold equity on the assumption that it would eventually be sold off.

Or you could substitute bonds for some part of the debt. And those, by breaking down this mound of debt, then, into digestible pieces, you can feed a secondary market that would allow the banks that don't want to hold these claims to sell them off at a discount, which I think is highly desirable.

This will ease the pain burden on debtor countries in addition to the emergency provision of reducing interest payments.

With regard to the multinational development banks, I will just make a few brief comments. I agree basically with what the others on the panel have said.

My only caveat, I guess, is that, first of all, I think we should be careful not to try to turn the World Bank into just another source of ready cash to countries. That's simply a waste of the contribution, the real contribution that they can make. I mean, I think, with or without the steps that I have mentioned, forced write-down and interest rate relief, there is going to be an extended hiaitus where there will be very little money forthcoming for these countries from the private banking sector.

The World Bank and the other development banks can fill an important gap there. But a lot of what they put in will be wasted if it just turns around and comes back as interest payments to commercial banks.

The other point is that I think it would be a mistake to push the MDB's too hard away from project lending. We roundly criticized the commercial banks for forgetting about project finance and losing track of where the money they were lending was going and what it was being used for. I don't think it's helpful to push the development banks down the same road. That doesn't mean that

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there shouldn't be innovation, things like the trust fund that the Inter-American Development Bank is discussing, or that there can't be lending for projects that would, for example, support the expansion of domestic financial markets in these countries, which I think is terribly important.

But this term "structural adjustment lending" is worrisomely vague to me and I think it would be a mistake to expect the MDB's to lower their lending standards just to push out more money in a year.

I will answer questions. Thank you, Mr. Chairman.

[The prepared statement of Ms. Lissakers follows:]

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Testimony by Karin Lissakers

before the

Subcommittee on International Development Institutions and Finance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

March 12, 1986

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Mr. Chairman, Members of the subcommittee, thank you for the opportunity to testify on the proposed "International Debt Management, Trade Promotion and Financial Stabilization Act." You have asked us to comment on what Congress can do to help resolve the debt problem and what can be done to enhance the role of the multilateral development banks. My remarks will be brief.

The Lundine proposal recognizes what even the international banking community is beginning to acknowledge, that Phase I of the debt crisis has run its course. The measures adopted after the Great Mexican Bust of August 1982 to contain the debt crisis did just that -- contained the crisis but by no means solved the problem. In many ways, we are worse off now than in 1982: the adverse impact on U.S. trade noted by the subcommittee is only one unfortunate consequence. A different approach to the debt problem is clearly necessary.

Action is required on two fronts, one involving the private financial markets, the other the World Bank and other official lending institutions. They are for the most part quite separate. The Baker initiative unfortunately created some confusion on this score by giving the impression that governments and the multilateral banks would somehow take the debt monkey off the backs of the private banks. The World Bank and the other development banks can ameliorate the worst consequences of the crisis for the

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debtors, but they can't solve the debt problem for the banks any more than the IMF has been able to solve it. It is still up to the private markets.

The first step should be for the commercial banks to give the debtors immediate relief on interest payments. The particular formula used -- a flat percentage cut, some ratio of export earnings, etc. -- doesn't matter so long as there is a significant reduction in the cash flow burden on debtors. Peru and Nigeria have already de facto been granted such relief. Others will follow. The debtors now realize that the bargain they struck with their bank creditors in 1982 is no longer on. The key elements of that bargain were continued full payment of interest by debtors--which protected the income stream of the banks--in return for the promise of future access to credit from the banks. But this bargain rested on the premise that "normal" bank lending would resume before the debtor countries had exhausted their tolerance for the economic and political sacrifices required to service their foreign debts without it. And after three years of considerable sacrifice by the debtors to uphold their side of the bargain, during which time developing countries have paid out more than $130 billion in interest, a resumption of "normal" lending is not on the horizon -- the Baker Initiative more or less officially acknowledged as much when it called for a mere 2.4% annual increase in commercial bank loans to 15 debtor

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countries over the next three years. The debtor countries now want a different deal that relies more on reduced interest payments than on new loans.

The U.S. government and the Congress should support their demands rather than pushing on the banks and the IBRD to lend more money that will just come right back as interest payments. Interest relief is the quickest way --and the least costly from a budgetary standpoint--to free up additional resources that would allow countries like Mexico and Venezuela to resume economic growth and give them some breathing space to undetake more basic economic reforms. The recent drop in market interest rates is helpful, but because this drop is tied to a decline in commodity prices, not all debtors have benefited.

Reduced interest payments would eliminate the need to run huge trade surpluses which so far have been generated largely by drastic reductions in imports. While the volume of exports from major debtors countries has risen somewhat, according to Morgan Guaranty's "World Financial Markets" (February 1986), the dollar value of their exports actually fell in 1985 over 1984. Only a 37 per cent cut in the value of imports from 1981-82 levels has enabled the ten Latin American borrowers listed by Morgan to maintain interest payments on their foreign debts. U.S exporters have been particularly hard hit. It is simply unrealistic to expect these debtors to open their markets to our goods so long as they have to make the kind of interest payments currently associated with their foreign debt.

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Interest relief would obviously cut into bank profits, but for most banks, not catastrophically. Interest income from the Third World has become a relatively less important source of profits at most U.S. banks and overall profitability is up sharply both here and in Europe and Japan. For a few banks that have recently shown losses, any fall in income from foreign loans would obviously be an added burden.

No major regulatory changes would re required to permit banks to accept lower interest payments. In general, I think the regulatory obstacles fo a sensible resolution of the debt problem have been exaggerated. If anything, the regulators have shown too much flexibility in allowing the banks to carry obviously value impaired laons on their books at full value. A tougher regulatory line would force the banks to deal more realistically with their foreign loan problems.

Interest relief is only a first step. Additional measures are needed to break up the logjam of existing debt that now blocks the flow of new credit and investment to debtor countries. The banks have not resumed 'normal' lending for a very good reason: they and the rest of the private financial market recognize that most of these debtor countries are still not credit-worthy.(Foreign direct investment in Latin America has dried up along with bank lending, and even their own people aren't willing to invest at home, hence capital flight.). Their foreign debts are

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much too large for their economies to support and they are therefore constantly vulnerable to adverse changes in the external economic environment, to a rise in interest rates, an economic downturn in the industrial countries, or as now, a sharp drop in commodity prices. The banks, too, are vulnerable. While the dangers posed by the exposure of U.S. money center banks to troubled debtors is much reduced because of recent additions to capital, the exposure is still uncomfortably high. The banks therefore will continue to resist any significant increase in lending to these countries.

The outstanding debt is also an obstacle to additional lending by official institutions. Despite the acute need for capital in these countries and plentiful mdb resources, lending by both the IDB and the World Bank was lower in 1985 than the year before. New loan commitments by the IDB were $500 million less in 1985 than in 1984 and almost a billion dollars below the projected target. Actual loan disbursements fell even more. The IBRD maintained new loan commitments, but disbursements were lower in 1985 than in 1984.

The problem does not lie with the development banks but in the recipient countries which lack the budgetary resources to provide the local counterpart funds required as part of the cost sharing in most mdb projects. And these governments are unwilling to start new projects such as schools, hospitals, and roads that will then require additional government expenditure for operating costs.

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The fiscal crisis is part of the larger debt problem. Government revenues are down because economies are depressed while debt servicing costs have risen. The Mexican government estimates that 40% of total government expenditures this year will go for servicing the foreign and domestic debt; an estimated 35-40 per cent the Brazilian government's revenues will be used for debt servicing. Much of the original foreign borrowing was of course done by the governments as was most emergency borrowing in the last three years. But the problems has been compounded by another little-noticed development: the commercial banks have insisted in some debt restructuring negotiations that the governments assume the foreign debt obligations of failing private sector borrowers.

Take the Philippines, for example. The public sector's share of all U.S. bank claims on that country increased from 39% in December 1981 to 61% of the total by September, 1985, Stated another way, while the total Philippine debt to U.S. banks rose only 2% in this period, the public sector's U.S. bank debt increased by 59%. Last spring I asked the head of the Philippine central bank, Jose Fernandez, Jr., about this phenomenon. He admitted that it was part of the deal with foreign banks that they be given the option of converting commercial debt, including claims on failed Philippine banks, to public sector debt. "That was part of the negotiations I didn't like, but I had no choice," he said. The same deal has been forced on other

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debtors. Brazil's public sector debt to U.S. banks has doubled, Mexico's has increased by 54% (not counting the foreign debt of the banks nationalized in 1982), and Chile's by 140%, since 1982.

This increased concentration of foreign indebtedness in the public sector is in my view one of the most distressing features of the debt crisis approach of the last three years. Rather than seeing a natural, gradual and manageble decomposition of some significant portion of the outstanding debt as private sector borrowers became insolvent and the banks wrote off their loans, we have instead had a concentration of the debt into one large, indigestible lump. Just imagine what the U.S. government's debt and budget outlook would be if each time a domestic oil rig supplier or farm equipment manufacturer went bust, Washington had to take over its debts!

I think at this point, some forced write-down by the banks of a portion of this debt is the only way to restore the economic viability and the creditworthiness of these countries. Substituting equity shares in state enterprises or longterm bonds that the banks would have to sell off, probably at a discount, would amount to the same thing. Such measures would permanently ease the payment burden on the debtors and make room on the banks' balance sheets for resumed lending, down the road.

Another way to shrink the debt is for the banks to disgorge some of the flight capital that has left the debtor countries illegally--often with their help. Banks

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should at least be asked to cooperate with legitimate efforts by debtor governments to track down this money. It would then be up to the courts with jursidiction where the money is held to decide if such deposits should be repatriated. .

With regard to the multilateral development banks, I agree with the Chairman's recommendation that the mdb's review their internal rules and procedures so that they can be responsive the needs of deeply indebted member states. The IDB has already speeded up disbursement procedures, reduced the counterpart funds requirement and allowed recipient countries to delay their counterpart contributions until a projects' latter stages. The bank has also agreed to cover operating costs for certain projects for some time after completion. The IBRD is said to be considering similar measures.

I also agree with the Chairman that the IBRD may be overly stodgy about protecting its one-to-one gearing ratio, although I defer to the greater expertise of the other members of the panel on this issue.

However, I think it would be a perversion of the original purpose of these development institutions if they were to become just another source of balance of payments finance, just another source of cash for debt servicing. There is a real and acute need for more lending by the development agencies precisely in those areas where these insitutions have traditionally concentrated a large part of

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their efforts --in the social sector, in projects that directly help the lowest income groups that have suffered most acutely in the debt crisis. If anything, the development banks should shift more resources into these areas precisely because debt strapped local governments are putting less money into them.

And in general, I think it would be a mistake to push the development banks away from project lending in the direction of "structural adjustment lending" -- I'm not quite sure what is meant by that. The commercial banks have been roundly criticized for abandoning project finance and losing track of the uses to which their loans were being put in the 1970's. Why send the development banks down the same road?

I'm not opposed to innovation, or linking lending by the mdb's with private sector loans and sharing the risks. The Trust Fund proposal under consideration by the IDB for example, could significantly increase the flow of resources to Latin countries. And the IFC has a new program that could tap sources of portfolio investment on behalf of developing countries. I just don't think the mdb's should lower their standards just to increase their volume of lending.

Finally, let me say a word about the debtor countries. I do not mean to absolve them from responsibility for undertaking economic and political reforms. But I dont think policy reforms can be imposed from outside, by the IMF, or by the World Bank or by the U.S. government.

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Let me remind you that the two debtors we now regard most hopefully, Brazil and Argentina, attribute their apparent success to programs that were adopted in partial defiance of the international creditor community. I therefore think one has to be realistic about the amount of leverage creditors can and should try to exercise at this critical stage of the debt negotiations.

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Chairman LUNDINE. Thank you.

Just so that my notes are clear, your third point discussed your observations about the MDB's.

Correct?

Ms. LISSAKERS. Yes.

Chairman LUNDINE. Mr. McCandless.

Mr. MCCANDLESS. I have listened with a great deal of interest and I have to what all three of you have said based upon a recent trip that I was able to participate in to Venezuela, Argentina, and Brazil. Each one of those countries has its unique problems within the structure of this discussion.

There seems to be a common denominator in all of these, and that is addressed in the Baker plan, one of the primary cornerstones for proceeding to the next step, and that is more privatization of the industries, economic reform, structural reforms within the countries, produce that base upon which, then, both the private and public institutions can feel more secure about how these restructured debts or augmented debts are going to be repaid.

You talked about this. Two of you addressed that issue. There seems to be a rather large amount of resistance based upon what people refer to as the sovereignty of the company.

Would you address that? And how do we get to that first base to be able to proceed to the second base and the third base and hopefully get home for a run? Mr. Baker is saying, frankly, that he is not going to come to the Congress and ask for additional levels of funding or credit for any of the institutions until such time as these other areas have been addressed, and then it makes it possible for him, with a certain portfolio, to come to Congress and also to the private lending institutions and partnerships.

How do we get to that first base?

Ms. LISSAKERS. I certainly agree that all of these countries need policy reforms. When one looks at Mexico, for example, one has a terribly stultified and rigid economic, political structure.

But I think we also have to recognize that there's a limit to how much leverage an institution like the World Bank or the United States through the World Bank and other institutions can exercise.

Countries have to find their own way to economic reform and economic health. I think there's a widespread recognition in these countries that they have to do things differently.

But the fact is that if you look at the bright spots that we now consider in the debtor constellation—Brazil and Argentina—they undertook programs that were quite strongly opposed at the time, originally, by large sectors of the international financial community, including the IMF, although in the case of Argentina, Paul Volcker overruled them.

But I think, first of all, these programs are not going to be effective unless they have some minimum level of domestic popular support. That support may be more difficult to win if it appears that something is simply being imposed from outside.

I think it is quite right to say, we won't lend unless we think the money we are lending is going to be put to useful purposes, unless capital flight, for example, is going to stop. Why pump more money in if it's just going to go right back out through corruption?

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So the lending institutions have to have standards, conditions under which they will or will not lend. But to come in and say, we want you to adopt a broad supply-side, our latest fashionable economic theory must become yours and you must officially subscribe to this and embrace it before the World Bank will give you another penny, I think is a mistake. It is a mistake politically and economically.

Mr. CLINE. The way you formulated the question suggested that if the countries didn't have a massive reformulation of the public sector, for example, that their economies would stagnate and the debt crisis would never be overcome.

The fact is that in Brazil, for example, a number of the state enterprises are pretty efficient. There have been scholarly studies which have found that the rate of return in a lot of these firms is as high as it is in the private sector.

It is true that there is a lot of waste in a number of public sector firms.

I think the point is that there should be no one part of the Baker plan that should be interpreted in an extremely rigid way as an absolute precondition for moving ahead, because the fact is that these things are more questions of degree than they are of life or death of the economy.

And in terms of degree, we do see a very keen interest throughout Latin America of moving toward privatization. Even before the Baker plan, Mexico said that they were going to sell off 236 state enterprises in order to reduce the budgetary deficits. Mexico is now talking about moving on other state firms. The Argentines are very interested in privatization.

This takes time. The experts who go in and transfer state firms to private firms can sometimes require 2 or 3 years to go through all the audits, find out what the firms are worth, et cetera.

I think the hallmark of applying the Baker plan should be one of building on the policy reform momentum that's already existing in these countries. It's true on trade liberalization, too. Mexico is going to join the GATT. That's a major turn-around.

So that if one views the process as more capturing this momentum and moving the countries further in that direction rather than having some specific target that might be unrealistic, impossible to meet, then I think the countries can move ahead.

And one of the reasons I believe that's possible is that I have a much different view from Karin Lissakers about the state of the debt problem. She acknowledged that in Brazil and Argentina, things are better. Well, they're a lot better. Brazil's oil imports could go to zero by 1990, not only because of lower oil prices, but because of self-sufficiency. They're producing a lot more oil.

That means that they're non-oil imports could grow about 20 or 25 percent a year and still achieve a $12 billion trade surplus. They are in a very favorable scissors of rising exports, and declining oil imports so that they can have rapid growth of the non-oil imports and therefore, of their economy.

They have just taken the courageous step to take care of the other crippling problem, which was domestic inflation. And by the way, after the new plan, their fiscal deficit is zero, because virtually the full fiscal deficit that they had was inflationary illusion. It

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was the inflationary premium in the interest that they were paying on their domestic debt.

So, I see what has happened as a concentration of the debt problem in the oil exporting countries. Look what's happened. We have much lower interest rates. OECD growth looks as if it could roll along for a while, partly because of lower oil prices.

Anybody who imports oil has enjoyed a windfall gain. One of the lagging parts is commodity prices, but I expect that to turn around because after the dollar has come down so far, at some point the markets are going to say, why not pay more dollars for the same copper, the same coffee, because, after all, the dollar is no longer worth as much?

That's going to push up those prices. So even the Chiles, who are already benefiting from lower oil prices, are going to have a stimulus.

I see the problem as concentrated in the oil producers and that means Mexico and Venezuela, when one talks about countries of magnitude. Venezuela has a cushion of about $15 billion of external financial assets. So it really means what do we do about Mexico?

Now, all of that, coming back to your question, it seems to me, says, we want feasible policy reform. I think these countries are prepared to take those reforms. We shouldn't be too ideological and too rigid about the aspirations that we have for those reforms. And I think even Mexico, despite its situation, can on a relatively normal basis—I don't think that we will wind up seeing interest foregiveness for Mexico, even—can manage.

Mr. SEWELL. Let me just reiterate a few points. All the experience with earlier versions of program lending and policy reform indicates that it only works where the government wants to move in that direction anyway. In other words the Government has a commitment to it already.

External finance, whether from the United States or from multilateral institutions, reinforces, supports, and greatly helps trends that are already in effect. There are many cases where the United States and others have tried to promote policy reform, most notably in the Philippines—and it just hasn't worked. The Government didn't want to make the tough choices and was very skillful at worming its way out of doing so. That, therefore, is an important consideration.

The other comment concerns timeframe and flexibility. After all, it's quite possible to even get a consensus in the United States about what to do about our own budgetary and trade deficit problems. To paraphrase: All we have to do is raise taxes a little bit and cut defense spending and a few other odds and ends and we won't have a budget deficit. There just seems to be a few political problems involved in reaching legislative action on that front.

The same is true in many Third World countries. The decision of Mexico to join GATT was equivalent to the United States deciding to join the United Nations. That was a major step which incurred high political costs. Countries are already taking these steps. We have got to give them time. And, of course, we are into the tough problem because we've got to bet money now on changes that are only going to pay off over some longer period of time.

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I am a little bit more pessimistic than Bill Cline, I must say, on the debt issue. My personal debt is very small relative to the U.S. national consumer debt. But if I can't pay it, it will cause a great deal of pain to me. Similarly there are a number of countries—smaller countries—that are still in terribly difficult debt situations.

Optimism since 1979 and 1980 on the debt issue has varied widely. Mexico is either the perfect case of adjustment or it's about to disappear. These things go up and down.

I don't know what's going to happen to oil prices. I don't know anybody who does. I don't think they're not going to go back up to their previous high. The number of variables in all of this are very great.

I'm sympathetic to Karin Lissakers point that countries have to get interest rate relief in the short run, if only for political reasons.

Chairman LUNDINE. Get what?

Mr. SEWELL. Interest rate relief.

Mr. MCCANDLESS. The renegotiation of the Brazilian debt had in it an interest relief, conditioned upon the fact that Brazil had made progress within the framework of addressing its internal problems.

Mr. SEWELL. Yes; but this is Bill Cline's field, not so much mine. My understanding is that it was only the premium that they were paying above the cost of money that went down, not the real cost of interest. The cost of the interest payments are still very high and this is going to cause political difficulties.

You must have picked this up in Latin America.

Mr. MCCANDLESS. $190 million a year. It's not insignificant.

Ms. LISSAKERS. It was a reduction in the spread over the base rate, and Brazil had been paying, had historically paid a much higher spread for some reason than Mexico.

Mr. MCCANDLESS. It was interesting that they used the carrot principle there as far as saying, you've done a good job of getting your house in order and we'll reward you.

If I may, Mr. Chairman, just one more quick one.

We talked here about writing off some of the debt. This has been stated before in other testimony earlier in this committee's proceedings last year.

What does that really accomplish. You still have whatever you have kept in the way of a debt. You have reduced the obligation, you have reduced the payment. But what has it accomplished because you still have a debt. What's the difference, whether the debt is 5 years more or 7 years more, whatever the numbers are? And then how do you reconcile that as far as the impact on our domestic institutions in writing that off?

Ms. LISSAKERS. It depends a little bit on the impact of how you do it. If you have a flat writeoff, a straight writeoff of some percent of the loans or a certain category of loans and you extinguish that debt, it's extinguished from the books of the bank, it's no longer a repayment obligation on the debtor.

If you have a conversion to equity, whether it's in state enterprises or private enterprises, then there's only an obligation to pay—first of all, there's no repayment obligation, per se——

Mr. MCCANDLESS. I want to separate equity from the actual writeoff.

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Ms. LISSAKERS. OK. If you have a bond—it's even possible to do a perpetual bond, one that never matures but simply has a low fixed interest perpetual servicing obligation which could at some point be repurchased by the debtor if you wanted to extinguish the servicing obligation.

As far as the institutions, it varies. The banks are in much better shape generally than they were. They are in better shape because earnings are up in this interest rate environment. They are in better shape because they have more capital relative to assets. They have loan loss reserves which are part of capital relative to assets.

Obviously, there are a couple of institutions for whom this would be really troublesome, a reduction in interest, and the Bank of America comes to mind.

But to gear your whole approach to the international debt situation because one or two institutions might be in trouble if you took a different tact, I think is not necessarily sound public policy.

For most institutions, certainly interest rate relief would be quite manageable. Yes; it would cut into profits, but no; it would not destroy the banks.

Let me just make one brief comment on loan loss reserves because there is legislation pending on this, and that's the tax reform legislation.

I understand that the tax reform legislation under consideration would severely limit the deductibility of loan loss reserves for income tax purposes to the banks. They could only take the loss when there was an actual writeoff of a recognized loss on the books.

I am not sure under the current circumstances that that makes sense. You want an incentive for banks to build up their loan loss reserves, even if they're not writing off, but against questionable loans.

It seems to me that it would be reasonable, rather than treating loan loss reserves as an addition to capital, treat it as a subtraction of assets, but allow the entire loan loss reserve to be deducted for income tax purposes. Deduct it from pre-income tax.

That's what the Europeans do and that's one reason the German banks, for example, have been willing to build up loan loss reserves much more substantially, so I understand.

Chairman LUNDINE. Thank you.

Mr. MCCANDLESS. Mr. Cline was going to comment as well.

Chairman LUNDINE. Maybe I will get a chance to question. Maybe I won't. [Laughter.]

Go ahead.

Mr. MCCANDLESS. I get ahead of you, see. [Laughter.]

Chairman LUNDINE. I used to think that this idea of letting everybody else testify made a lot of sense because the chairman has to sit here until the end of the hearing, anyway. The last hearing we had, I didn't get to question at all. I am determined to avoid that.

But Mr. Cline, having been admonished, please do make your comment.

Mr. CLINE. I consider myself so, and will be brief.

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I would note that the Institute for International Economics published a monograph last year on a whole range of something like 20 different alternatives for dealing with the debt problem and included specifically interest forgiveness, writeoffs, et cetera. It attempts to look at the impact on the country, the impact on the banks, the impact on the regulatory issues.

So I would suggest that as a resource that can be drawn on to look at this.

Of the things that struck us in dealing—we prepared this study in consultation with a lot of banks. The idea of writing off debt, even by a lot of the smaller banks who are more sympathetic to some of the different approaches seemed to be treated by on the basis that while they might write it off in their books, they would not write off the claim against the country, that they would consider that they maintained their claim against the country.

So I would tend to agree with you, Mr. McCandless: What does it accomplish?

It seems to me that the principal thing that you can be sure that it accomplishes is to knock that country out of the capital market for another decade or so. After all, we had a lot of defaults in the 1930's and the capital market was virtually nonexistent for these countries until the late 1960's and early 1970's.

Now the countries can choose whether they want to repeat that experience or not. I think that certainly, countries like Brazil have no intention of repeating that experience. I think even Mexico can avoid that kind of repetition, although I must say it causes me concern to see the Mexican Government talking about below-cost interest, and that's what interest relief means in that sense, below LIBOR, because, in a sense, they are voting by their feet that they don't think that they will have much access to the capital markets even in the 1990's, or that the current Mexican administration only has a time horizon of 3 years and it is not prepared to take a long-term view of Mexico, which may also be part of the package.

But that disturbs me.

Chairman LUNDINE. I want to get at these two controversial recommendations you have made, Ms. Lissakers.

Let's stay with what we were just on. You said, forced writedown of these loans may be converting it to equity.

Who's going to force it? That's one thing I don't understand.

Ms. LISSAKERS. Well, you can force it by not giving the banks any option.

Chairman LUNDINE. Take away their income tax deduction? Just play hardball with them in regulation.

Ms. LISSAKERS. Well, you would have a progression. If you just let it happen, you would have a progression where a country, because of the World Bank or the United States, no one is willing to put up the money to Mexico. The Mexicans do what they have done, which is to say, OK, we will pay you 15 percent or 10 percent or 25 percent of our exports.

Chairman LUNDINE. But then, as Mr. Cline points out, the risk for them is they are going to be forced out of capital markets for a long time.

Ms. LISSAKERS. But I think what they have concluded is that they are already out of those capital markets for a very long time to

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come and there's nothing in my conversations with commercial *bankers, anyway, to refute that.*

That's what I mean that I think everybody recognizes in phase 1, that the sacrifices that the Bank and these countries have made to the interest payments are no longer worth it because they are not going to get what they were promised at the end of the road, which has resumed normal borrowing in the credit market—the longer they undermine their own economies in order to keep on the stand in this treadmill. But in some ways, the day they can go back to the credit markets becomes further and further removed.

Chairman LUNDINE. So, basically, you are saying there's no role for our Government or the MDBs or anybody like that to play in it, that when this situation gets bad enough, then the Mexicans will be willing to convert some of their debt into equity shares in PEMEX or something and it will take care of itself.

Ms. LISSAKERS. No. I am saying that's one way of forcing the situation. No, I think what makes much more sense is to take a sort of approach that the Baker initiative seems to suggest and to say to the banks, OK, the Mexicans—you, the banks, by yourselves, are not prepared to put up enough money for Mexico to recover its financing gap for this year. Let us do something else.

You, the banks—I mean, you can even give banks the option—your contribution can be either in the form of interest rate relief and/or some conversion of some proportion of your Mexican portfolio to equity—I mean, the Mexicans can design various instruments and let the individual banks pay on an individual basis——

Chairman LUNDINE. The U.S. Government would say that to U.S. banks. That's another question, how do you reduce the interest payments to the LDCs? We're going to turn to the banks and say, you'd better do this?

Ms. LISSAKERS. Well, what we have had in the past in debt restructuring negotiations is a sort of parallel track between, say, the IMF and the commercial bank negotiations and the Paris Club debt rescheduling. And there's a lot of official debt involved in this, too.

You have had whole rescue packages for Mexico in the past where you had some component of official loan, both bilateral and multilateral, from the IMF, from the World Bank, and from the IDB. You have had some component from the banks in the form of forced new lending and stretching out of principle.

So I am just saying that that package now should have some different components that would not only give these countries an infusion of cash over the short term, but that would do something to reduce this amount and lower this debt.

Chairman LUNDINE. Do I take it that you and Mr. Sewell would both think that some kind of a facility might be a reasonable idea? A facility where existing debt could be converted?

In other words, a bank holds so much debt of one of the LDC's, that they could turn it in to some international facility and get 85 cents on the dollar? Or if they're willing to stretch out their loans, that there will be some joint facility that will work?

Are you saying that is a good idea?

Ms. LISSAKERS. No. I think, A, it's too expensive and B, I don't think it's necessary. I don't think that you have to call on United

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States budgetary resources to buy out Morgan Guaranty's Mexican portfolio, even at a discount.

I don't think that's necessary. I don't think that's desirable. I think the market can do it itself, but it can be part of a larger package where there are commitments of resources by official institutions also.

Chairman LUNDINE. America will only do it when it's our policy that that ought to happen—in other words, the Baker initiative would be changed slightly. Vague as it is, it would be changed slightly to encourage a reduction in the amount of the interest rates.

Ms. LISSAKERS. And in the outstanding debt.

Chairman LUNDINE. Yes.

Ms. LISSAKERS. Rather than simply adding to the debt. That's what I'm saying. I am not sure what the Baker initiative is except a sort of——

Chairman LUNDINE. I would appreciate one redefinition of a term here that I don't know. I would much rather call it an initiative than a plan because I don't think it's much of a plan, at least not one that I can understand. It is an important initiative and I said at the outset that I called it a plan in my opening remarks and I stand corrected.

I think it is a worthwhile initiative and I gather all of you do, even though you come at it from very different points of view and arrive at some different conclusions. But we are groping really for a plan and none of us have one.

Do you disagree with that, any of you?

Mr. Sewell, you discuss a couple of things, but didn't come to any conclusion that I could understand. One of them is whether the World Bank is capable of undertaking this institutional transition to deal with the debt crisis, largely from an institution involved in project lending and almost exclusively to one that would be very much at the center of efforts to meet the problems of the LDC's in the late 1980's and 1990's.

I didn't really understand your conclusion.

Mr. SEWELL. That's probably because I didn't reach one, Mr. Chairman, very carefully. [Laughter.]

Chairman LUNDINE. I suspected that.

Mr. SEWELL. You caught me at it. [Laughter.]

Let me go back through it. The Baker initiative implies a tremendous task for the World Bank. The amount of money we are talking about for the World Bank is not a great deal compared to the amount of Third World debt, the amount of private capital flows, and the amount of trade flows. So the question is at what point is it going to be crucial in terms of dealing with these financial imbalances?

Second, the amount of resources available should force choices about country and program priorities. There is no thought that the World Bank should assume all of the responsibility for the debt crisis. It's clearly impossible and quite undesirable. But the World Bank has grown over the years to be a really quite effective project lending institution. That is where the institution has put its weight in terms of its staffing and in terms of its abilities. It evaluates, works with host governments on projects, whether they're huge hy-

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droelectric projects or health care projects, really quite well. Its research also has been geared traditionally in that direction. And its evaluation activities have been geared in that direction.

Howevery the Banks now will be asked to undertake a major diplomatic role in dealing at a very high level with governments about changes in the basic policies of the recipient governments.

There is a real question of how fast the Bank can make that transition in management style. They are going to have to deal on a very high level and with very sensitive issues within those countries, and will have to have a fine sense of the politics of the issue—how much a Mexico or a Brazil or a Nigeria can be reasonably expected to adjust.

There is relatively little disagreement about correct policies but, there is very little knowledge about how you get from bad policies to wise policies over a period of time. And progress is not as easy to measure as balance-of-payments gaps or inflation rates.

Therefore, the issue concerns the capabilities of an institution. I am not saying the Bank is not capable; it is. But the Baker initiative puts a lot of responsibility on the Bank's shoulders that's going to require quite an organizational——

Chairman LUNDINE. So as one who is probably trained to push the Baker initiative to be more aggressive, you are cautioning me that maybe they don't have the capacity to——

Mr. SEWELL. No. I'm saying developing the capacity will take time. By the way, the United States has a challenge here too. The U.S. input into the World Bank comes from the Treasury Department. You are asking Treasury's input to be highly developmental. And I differentiate this from financial. What's the relationship of Treasury to the U.S. Government's developmental capability, which is AID? There is no AID or very little of it to input to the World Bank.

There are a whole set of questions here which come back to the fact that the United States has put very little emphasis on development in its foreign policy.

The Bank will be dealing not only with the Baker plan countries, but with a whole range of other countries which get U.S. aid, in some cases a lot of U.S. aid.

How does that run in parallel with what the Bank is doing in those same countries? Does it run counter to it? Is there any relationship whatsoever?

Chairman LUNDINE. Mr. Sewell, I understand you have to leave and I want to thank you again for your testimony.

Mr. SEWELL. I apologize.

Chairman LUNDINE. Mr. Cline, before I just let you have a freebee on what he said, you seem to be, in this group, at least, the one that's saying, there isn't that big of a problem and it's manageable. But, can you expect the Mexicans to continue to reduce their standard of living as they have in the last few years?

Isn't there a real problem, viewed from the standpoint of most of the debtor countries, not just in Mexico? I did pick on the most dramatic example, to be sure. But it's even a tricky question of whether other countries—Argentina, for example—are going to be able to make it through. We are all hoping that they will.

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But it isn't really quite as rosy a picture as you paint, is it? These countries are really being asked to make considerable sacrifices, made, from their point of view to pay off U.S. banks.

Mr. SEWELL. You're asking Bill Cline?

Chairman LUNDINE. I am asking Bill.

Mr. CLINE. I think that it's possible for Mexico to manage at $15 a barrel with a $6 billion package that involves $2½ billion of new money from the banks, which is the way it's shaping up now, without having massive cuts in GNP. They were already planning on zero growth this year to get their domestic inflation under control.

I think that the external adjustment has to be done primarily by expanding non-oil exports. And as the Brazilian experience has shown quite dramatically with 8-percent growth last year, it's possible to have both adjustment to external shortfalls and growth by doing it through export expansion.

I expect there will be some recession this year in Mexico. I think the answer to your question is, no, one cannot expect Mexico or any other country to have 5 or 10 years of negative growth, or even zero growth, to manage the debt problem.

I don't think it requires that.

Chairman LUNDINE. So, along with me—in picking up on what Mr. Sewell was just saying—along with me, you would concede that it's a pretty big job if we are asking the World Bank to thrust itself into this longer term problem of debt management. It is a pretty delicate job to ask them to do.

Mr. CLINE. Well, I think they have to do it.

Chairman LUNDINE. I do, too.

Mr. CLINE. I would like to dispell a little bit the notion that the World Bank is kind of at the margin, it's not all that big an actor, et cetera, that seems to be coming up here.

The numbers are rather more persuasive of how important the Bank can be. Basically, the developing countries now are running an external deficit somewhere in the range of $40, maybe $50 billion.

The World Bank's net disbursements under the Baker plan would go to $9 billion a year. If you push it a little bit more, maybe you could do more.

So you're talking about almost a quarter of the financial needs right there. It can be done in a way that's leveraged with co-financing of private bank lending. I think it's potentially a dramatic actor. In a sense, I think it's essential to move the Bank from being perhaps too comfortable, cautious, and very interested in getting good returns on its financial float in the market, having precious projects that never go wrong; and move them faster so that more volume is moving.

I think it's going to be difficult, yes. I agree with that. But I think it can be done. I think it has to be done.

Chairman LUNDINE. I do, too. But—let's try to play the devil's advocate. Because of the recent publicity and one of the witnesses—I can't recall who—mentioned it, about the Philippines. It does raise the question that you also have to be sure that you are not just pouring your money down a sewer and that corruption doesn't result in a dissipation of what would be growth, the eco-

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nomic development aspect of this sort of loan or this sort of an investment.

We could hardly argue that the conservative way the World Bank goes about doing project lending and disbursing its funds and all that, mitigates against the kind of corruption that is being given a lot of publicity. It may have occurred in the Philippines.

How would either one of you respond to that concern, that if we're going to push the World Bank to quickly adapt to a new role, how do they take action to assure us that those structural adjustment loans or other disbursement aren't going to be corrupted to the extent that they won't have their desired impact?

Mr. CLINE. If I may, it seems to me that the key issue is whether there is a lot of capital flight. I think concerning the modality of a strong-arm regime that is corrupt and walks away with $10 billion, fortunately, historical change limits that prospect because we now have democratic governments in the key debtor countries.

There is a lot of concern at the World Bank and among the private banks, however, that money poured in the top will just come out of the bottom in capital flight.

The proper way to address that is to make sure that the key economic signals that prompt capital flight are not present. Those signals are negative domestic real interest rates, which give an incentive to take your money abroad, unrealistic exchange rates, which means you take your money abroad because otherwise, you know that you're going to suffer an exchange rate loss because there will inevitably be a devaluation.

Those have to be fundamental parts of the World Bank's conditionality and those are really a mapping from the IMF's existing conditionality. Those are key conditions that the IMF insists on, and properly so.

I might say that the image of massive capital flight out of Mexico is an unfortunate misperception because the period of massive capital flight from Mexico was prior to 1982. Since then, the Government basically has not been turning over large amounts of its scarce reserves for Mexicans to convert pesos into dollars and take them abroad.

There are specific aspects to the Mexican balance of payments that give something of the impression of capital flight. I can go into that if you want.

But Mexico is not experiencing massive capital flight and it's unfortunate that the banks have the impression that it is.

But that is where I would place the locus of avoiding this hemorrhaging that previously in some cases occurred with corruption.

Chairman LUNDINE. Can I pick up on that point and then direct a question to you, because I understand that you've written or advocated amending the Bank Secrecy Act to make it easier to identify deposits in U.S. banks which represent flight capital.

That is an interesting idea, but wouldn't you have to do something on an international basis? Wouldn't we be making a terrible mistake in the United States if we were to say, we are going to develop mechanisms to identify capital flight into the United States, but you can still put it in Swiss bank accounts or, for that matter, German, or any other?

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Ms. LISSAKERS. The basic point, and there was an op-ed piece last week in the Times on this issue, the basic point I was trying to make, that the banks, and the commercial banks really talk out of both sides of their mouths on this question of capital flight—I agree completely with the basic reform, the basic change in capital flight patterns is a result of domestic policies of governments. It's a question of both the level of corruption and the macro-economic policies.

The fact is that the commercial banks have done, the same banks who were lending these countries the money have been doing a booming business helping people smuggle it out of the country, either illegally or perfectly out in the open, legally. It was legal, for example, for a long time for Argentines to have foreign dollar bank accounts. I talked to the banks in Buenos Aires and they have an office that does nothing but take dollar deposits.

That's fairly straightforward.

My problem comes with some examples I was given in conversation with American bankers. For example, it was quite a common practice for Venezuelan businesses to deposit dollars, not just Venezuelans, but others, to have a dollar deposit abroad under one name at a bank and use that money as collateral for a loan that was taken under a different name, maybe a company name. The collateral was under the account of an individual. And to take that loan, the dollar loan, home, convert it at a highly favorable rate into the local currency. You earn interest abroad tax-free. You get a tax deduction on the interest you're paying. The loan, the foreign loan, is registered with the local government, with the Venezuelan Government. You get a tax deduction for the interest you pay on that foreign loan. Unbeknownst to the Venezuelan Government, you have this collateral backing. And then you get a devaluation and real debt crunch.

And the Venezuelan Government is saying, the company comes to the Venezuelan Government and says, gee, we can't afford to repay this loan at the devalued rate, or we're going bust and you, the Venezuelan Government, have to take up this loan, without admitting that there's collateral. The Venezuelan Government then goes to the banks and says, then we suspect that there's a lot of Venezuelan money in your accounts, but under different names. And the banks simply say, well, gee, we are sorry, but there isn't any deposit under this particular company name that borrowed the money. It's collateral under a different name, but we, the bank, are not going to volunteer this information, the Bank Secrecy Act, et cetera, et cetera.

I am simply saying that under those circumstances, it doesn't make much sense for there to be a huge effort to save Venezuela when, in fact, there's plenty of Venezuelan money to pay off the loans, even by the same individuals who borrowed it, and that the banks should be forced to accommodate these kinds of inquiries. And the Marcos situation is another obvious instance.

I mean, I think one has to be careful about lifting bank secrecy, and I also absolutely agree that that should be a broad-scale international effort.

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My basic point is simply that the banks play a role in promoting capital flight and maybe they should think twice about being so accommodating.

Mr. McCANDLESS. If I may, Mr. Chairman——

Chairman LUNDINE. Yes, Mr. McCandless.

Mr. McCANDLESS. While we are on that subject, and I won't take as much time as I took the last time.

Panama now has about 150 banking institutions. The dollar is the currency used there, native to the country. It appears to me that in the grand scheme of things that we are talking about, that's a rather severe hole in the dike as far as this money payment of capital flight, particularly in the Western Hemisphere.

Is this a correct assessment or is it overstated? Because of the complete secrecy, they have built this tremendous industry employing something like 8,500 people in all these institutions. It would appear that that's a rather severe crack in the dike, but maybe not.

Ms. LISSAKERS. Well, Panama is just one of many bank havens that have various degrees of secrecy.

The fact is we know that there are lots of dollars out there, both in terms of bank accounts, debits and credits on accounts. But it appears now—the Fed just tried to account for where all the cash that has been issued by the U.S. Government is. And they found that they're missing $133 billion of cash that they can't account for in the domestic accounts.

The assumption of the Fed seems to be that it's out there abroad. One assumed that there was very little cash actually moving in and out of the country. It now appears that there may be a good deal of U.S. cash floating around in people's mattresses and bank accounts and so on, rather than simply a movement of deficits and credits.

I think, on the Mexican—some of these numbers may not show on the Mexican account. Mexico is a very special situation because of its proximity to the United States and the long border. My understanding is that there is a lot of traffic, that a lot of banks on the United States side of the border are perfectly willing to convert pesos to dollars at highly favorable rates to the banks because the border banks have uses for the Mexican pesos that they take.

So that the dollars aren't originating in Mexico, but are actually originating here and what you have is that the capital is fleeing Mexico in the form of pesos rather than the form of dollars or other hard currencies. But I have no fix on how big a business that is. I've just been told that that goes on.

Chairman LUNDINE. Mr. Levin?

Mr. LEVIN. I came back really just to express my regret. I missed the testimony. I was testifying downstairs before the Banking Committee and it went on much longer than expected. Otherwise I would have been here.

I just wanted to say, Mr. Chairman, I guess you are ready to wind up—I just join you and my colleagues on the minority side in thinking this is such a critical issue, that it is well that you are initiating this series of hearings.

I sense that there is a feeling of inevitable drift about this whole area and that somehow, we'll land on our feet and just let it be.

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The Secretary initiated a program and it's had trouble getting off the ground. I just wanted to express not only my interest, but my feeling that what we're undertaking under your leadership really hopefully will have some significance.

Chairman LUNDINE. Thank you.

Thanks to both the witnesses who are remaining for your time and your insight. It certainly advances the cause that Mr. Levin just put forward. And even though there's not an absolute consensus of opinion, that's exactly what I want and I feel this subcommittee needs right now.

I have not introduced the bill because I think it ought to involve considerable discussion. You have given me a clearer perspective on some of the issues and I really thank you greatly for being here and for doing that.

The subcommittee will be adjourned. I would remind both members that we have an informal meeting with Ambassador Yeutter tomorrow. He did not want to testify formally, but we may be able to learn even more at an informal meeting.

[Whereupon, at 11:55 a.m., the hearing was adjourned, to reconvene subject to the call of the Chair.]

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THIRD WORLD DEBT LEGISLATION

TUESDAY, MARCH 18, 1986

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:05 a.m., in room 2222 of the Rayburn House Office Building, Hon. Stan Lundine (chairman of the subcommittee) presiding.

Present: Chairman Lundine; Representatives Torres, Levin, Bereuter, and McCandless.

Chairman LUNDINE. The Subcommittee on International Development Institutions and Finance will come to order.

This morning's hearing is the second in a series of four hearings which the Subcommittee on International Development Institutions and Finance is holding to solicit reaction from expert witnesses on proposed legislation addressing the international debt problem.

The debt servicing requirements faced by the developing countries and the accompanying pressure to maintain large trade surpluses has had a stifling effect on the growth prospects of the debtor countries. Inhibited economic growth in the debtor nations has in turn increased the risk to our own and the world's financial system because this debt service has claimed an ever greater portion of debtor country export earnings.

The key, then, appears to be restoring healthy economic growth in the debtor countries. Part of the answer lies in maintaining economic growth in the OECD to help sustain the demand for developing country products.

Part of the answer lies in economic policy reforms in the debtor countries themselves.

Finally, continued financial flows will be necessary from both public and private sources to furnish the needed resources for investment in the developing countries.

The legislative proposal that we have put forward attempts to complement the Baker initiative and places an important emphasis on growth. In addition, we recognize that the commercial lenders, as well as the MDB's, must remain significant players in the game.

We would like to learn at this hearing to what extent commercial lenders intend to remain players while at the same time safeguarding their soundness.

We have proposed that Treasury study a number of options. These include the stretchout of writeoff periods, encouraging the

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growth of the secondary market for developing country debt, and creation of a World Bank administered fund to mobilize additional commercial bank lending.

We want to learn from the banking community and other experts which of these options, if any, might be viable as a means of attaining the twin goals of banking system safety and soundness and increased capital flows to the poor countries of the world.

Today, we're pleased to have before us two highly qualified individuals who will discuss the future role of the commercial banks in working toward a resolution of the developing country debt problem.

Our first witness will be George Clark, executive vice president of Citibank. Among his various duties at Citibank, Mr. Clark oversees the setting of country risk exposure limits. Prior to his tenure with his current employer, Mr. Clark was with the International Monetary Fund.

Our second witness will be Dr. Riordan Roett, director of Latin American Studies Program at the Johns Hopkins School for Advanced International Studies. Dr. Roett serves as a political risk consultant for Chase Manhattan Bank, and along with numerous written achievements, is considered one of the leading experts on the country of Brazil.

Mr. Bereuter, the ranking member, I believe he will be joining us shortly.

Mr. Clark, we are looking forward to your testimony, unless Mr. Torres has any opening statement.

Mr. TORRES. No statement, Mr. Chairman.

Chairman LUNDINE. Thank you.

Mr. Clark.

STATEMENT OF GEORGE J. CLARK, VICE PRESIDENT, CITIBANK

Mr. CLARK. Thank you, Mr. Chairman.

I have prepared a written statement which I believe is generally available here. I think it might be more fun and I can be more brief if I make some straight comments which come out of the statement.

Chairman LUNDINE. Without objection, your entire written statement will be made a part of the record. We would appreciate any summary that you can make.

Mr. CLARK. Thank you, Chairman Lundine.

I find this is a subject that we get a pretty good dialog going pretty rapidly. So I think a long opening statement probably isn't necessary.

There are three or four points, though, that I would briefly like to make at the beginning. First of all, Mr. Chairman, I would like to say that, the commercial banks, are very pleased with the initiative that your committee is taking in this regard. And when I say that, I have something quite specific in mind.

You know, we sometimes feel a little abandoned in this effort of dealing with the debt problem. You recall the whole debt issue started in 1974 with the OPEC oil increases. I remember in September 1974 being here in Washington and hearing a lot of statements about how the global payments mechanism was greatly at

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risk because you were going to have the enormous surpluses of the OPEC countries and the enormous deficits of the developing countries, and that the two couldn't be bridged and there would be a breakdown in the system.

And if we read the Wall Street Journal of those days, we would find some pretty dramatic statements being made about the threat to the system.

What happened was that the commercial banks did step in and bridge the gap between the deficit countries and the surplus countries. By 1978, we pretty much had the problem whipped when we had the second go-around of OPEC price increases. Once again, we found these deficits and surpluses emerging.

So, once again, the commercial banks stepped in and bridged the gap and I think we did keep the global payments system together. The thing got a little out of hand in 1981 and 1982, but if it hadn't been for the role of the banks, I think we would have had really serious financial crises in the 1970's.

I think that very little recognition is given to that role that we played. I detect in the efforts of your group an effort to try to work with the financial community in trying to arrive at some joint solution to the situation in which we now find ourselves.

So I want to say on the part of the industry that I represent that we very much appreciate these initiatives. I think the spirit—I know you're still working on it and so on—but I think the spirit of the effort is very positive and it's one that we bankers would want to do everything we can to help you with.

Another general comment that I wanted to make is that when all is said and done, the way we will get out of the debt problem is, first of all, by development of better programs at the country level. We still find that many of the developing countries of the world have very large public sector deficits. They have high rates of inflation. They have low rates of domestic interest. And they have over-valued exchange rates.

And under these conditions, you get very strong subsidies for capital flight and these programs tend to discourage domestic investment of domestic resources.

I note that also in this area, your drafts recognize the importance of developing at the country level appropriate country programs to deal with the balance of payments and with economic development.

I was very pleased. I was in Seoul at the time that Secretary Baker gave his talk. And about the first half of Secretary Baker's talk was in terms of the establishment of criteria, performance, the need for the countries to help themselves, or there's very little that we can do to help them.

So here, again, your drafts are very supportive of that direction. We have to have good local programs if we are going to be able to help these countries achieve economic development. And your papers also highlight the importance of capital flight. The reason that we have capital flight from these countries in many cases is because the markets are flooded with domestic liquidity because of the public sector deficits and the money creation that goes with that and then the tendency is to have over-valued exchange rates, so that the cheapest thing to buy in the market are dollars.

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This takes the savings of the country out and we have to deal with that. And your effort is aimed at dealing with that.

I would also like to say that the emphasis that you give on the structural adjustment loans is right on. I just happen to come back from Africa. I have been in eight African countries in the last 3 weeks. We have a number of structural adjustment loans that are being worked on there. I could cite, you know, the specific cases—Senegal, Zambia, Morocco beingthree very good examples where structural adjustment loans are in place and they are effective.

You are right on to be providing that kind of emphasis.

So in all of those areas, we feel that this is an extremely positive thing and we are very anxious to provide any support we can.

As far as the Baker initiative goes, we, as an industry, have already submitted in writing to the Secretary our commitment to provide the financing for these programs provided we can get adequate programs at the country level.

When I say "we," I am not only thinking about the U.S. banks. The global commercial banking community has responded in writing to Secretary Baker in support of these programs. All of that would be entirely consistent with what you are including in your proposed legislation.

One negative point I do want to make at this time is that we do have in the Congress now various proposals that relate to tax issues on our overseas lending. H.R. 3838, for example, specifically would deprive us of the use of our local tax credits against U.S. taxes for U.S. tax purposes.

If that went through in its present form, it would greatly inhibit the possibility of American banks participating actively in this initiative.

So we do have to look at the tax impacts of the withholding tax at the local level on the loans that we would be making under this initiative.

I testified before the Senate Banking Committee on this and I pointed out that the U.S. Treasury, in the form of Secretary Baker, has got kind of a dilemma on its hands here. He would like to see H.R. 3838 go through, but he also recognizes, and I think since I testified, he has publicly indicated that he recognizes that there is a paradox here and it's something that we have to work out jointly.

Just one other point and then I will terminate my opening statement.

I think, Chairman Lundine, what we are basically dealing here with is how we perceive the role of the World Bank in stimulating these capital flows. For 40 years now, the World Bank has basically done its own thing and done it very well. We now are asking ourselves, to what extent might we involve the World Bank in working with the capital markets of the world to step up lending to the LDC's? And obviously, that's something that we want to work on.

The dilemma comes in that, to the extent to which the World Bank involves itself in our activities, they may help us in reducing the risks that we have in some of these activities, but they may do it by increasing the risk that the World Bank has in these activities. There are lots of proposals—we'll talk about them today, I suppose. There's cofinancing. There are cross default arrange-

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ments. There are some suggestions about discount facilities and in some cases, some outright guarantees.

To the extent to which the role of the World Bank is altered by involving itself in assuming one way or another the risks of the commercial banks, we sort of profoundly change the basic role of the World Bank.

It's a little hard to have it both ways. Either they become involved, they assume some of the risks, and the commercial banks are encouraged to lend, but you sort of change the flavor of the World Bank as an entity, or we continue to do our own thing separately—the World Bank continues to do its own thing separately. And maybe as a result, the commercial banks lend somewhat less than they would otherwise lend because they would continue to carry the risks by themselves. And I think that that is kind of a basic issue that will come up.

In your opening statement, you mentioned, for example, the possibility of the creation of a World Bank administered fund to mobilize additional commercial bank lending. That might be a very, very good idea, but I think we would want to understand to what extent it meant that we had some less risk, in which case we would make more loans and in which case the World Bank might have some more risk, in which case that would be a departure and it might affect their rating in the capital markets and so on.

So those are the tradeoffs that I think we need to understand better as we consider this legislation.

Thank you very much, Chairman Lundine.

[The prepared statement of Mr. Clark follows:]

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STATEMENT OF

GEORGE J. CLARK,

EXECUTIVE VICE PRESIDENT,

CITIBANK, N.A.

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT

INSTITUTIONS AND FINANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

TUESDAY, MARCH 18, 1986

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Mr. Chairman and Members of the Committee, I am George J. Clark, Executive Vice President of Citibank. I am pleased to appear today in response to the Chairman's invitation to discuss the international debt situation and the elements of an effective strategy to deal with these problems. I have also reviewed, at your request, a draft legislative proposal and will have some comments on some relevant U.S. Government policy issues in this regard.

First let me commend the Subcommittee on its role in pointing out the importance of these issues and, especially, the ways in which the activities of the multilateral development banks and the IMF have so clearly served the broad economic interest of the American people. Last year's hearings, held just prior to the IMF/World Bank annual meeting in Seoul, and summarized in your report "Dealing with debt, rekindling development: the U.S. stake in the performance of the world's development banks", accurately described the background and anticipated several of the key policies which emerged from that meeting.

Secretary Baker's proposal as announced at the annual meeting encompasses the most vital ingredients of an effective approach to the international debt problem. As it has been greeted with a certain amount of misunderstanding

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and erroneous reporting in the press, including several pronouncements that the approach is doomed to failure, permit me to try to explain what we consider that initiative to be all about,-- and, equally importantly, what it is not.

I see Secretary Baker's concept as a recognition that several sets of key players must act in concert if the debt problem is to be most effectively addressed: those key players include the multilateral official financial institutions(IMF and World Bank Group), the commercial banks, and the governments involved. None of these institutions can successfully resolve the problem alone, and each must have confidence that the others are carrying their share of the program.

Therefore, to those who have expressed impatience for immediate results and have already published premature obituaries for the program, I would point out that what Secretary Baker outlined was a process. Furthermore, many of the specific parts of that process have been left for those most directly affected to put into precise shape. Since the most critical role is that of the borrower governments themselves in getting their policies corrected, it was clear that the process would require time and some patience.

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Another key aspect of the Secretary's proposal is that it does not discard the case-by-case approach in favor of some simplistic "cookie-cutter" scheme, but rather recognizes the uniqueness of each debtor country's circumstances and the soundness of continuing to address these countries and their problems individually. Clearly the list of 15 countries cited by the Secretary includes economies of differing characteristics and vulnerabilities, incorporating both oil exporters and oil importers, differing political circumstances, and so forth.

The most important key to the success of the strategy will be, as I have stressed in other appearances before Congressional committees, whether the borrowing countries themselves can get their economic policies right. This has always been much more critical than the points often receiving public attention, such as forecasts of financial gaps and of whether and where corresponding levels of financing will be marshalled. I refer to such basic elements as realistic exchange rate policies, positive real interest rates, dismantling of excessive domestic subsidy programs and other burdens on government budgets, etc.

This is not to suggest that important steps have not already been taken. The improvement in the LDCs' external

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accounts -- balance of payments current accounts -- since 1982 has been dramatic, as other witnesses have testified. The world has not experienced the massive general collapse some observers predicted. And on their parts the banks have significantly increased their capital and are therefore in a stronger position to deal with the LDC debt situation.

But important problems remain. The special challenge of how to reverse the flows of flight capital from the problem countries deserves special mention. In my judgment no external institutional programs can play as critical a role as the debtor countries' own economic policies. It is these which so often subsidize capital flight. And in turn, if the problem is not successfully addressed, one can hardly expect the commercial banks to invest more funds as called for under the Baker plan.It is difficult to convince foreign investors to invest if local residents are encouraged by their own governments' policies to move their capital elsewhere.

More broadly, the entire range of LDC government policies affecting foreign investment should be most carefully reviewed with an eye to removal of those which create disincentives to foreign investors. It is clear that the development of these countries cannot be entirely fueled

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by loans from the multilateral development banks and commercial banks, and other sources of capital must be identified and tapped. Only a move toward more attractive policy environments can bring this about.

As your proposed legislation indicates, the World Bank certainly has a growing role to play. I share fully your perception that the most essential factor in that role is not so much the level of World Bank resources but rather the conditionality attached to its lending. Whether through strengthened Structural Adjustment Lending programs or other means, the World Bank must become, as the IMF has long been, more of a force for sound management of LDC economies. Its own resources will only be supplemented by private capital in needed amounts if such conditionality can succeed in improving economic management in the countries involved.

The Subcommittee's draft legislation addresses certain questions of U.S. law and regulation affecting banks. I would comment that there are, in addition to those cited, other issues of U.S. policy facing the Congress this year which may have an even more profound impact on the commercial banks' ability to carry their share of the Baker program. I refer to some of the proposed changes to the treatment of foreign income under the Tax Reform Bill, H.R.

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3838, on which I have recently testified before the Senate Banking Committee. Rather than repeat in detail what I said on that occasion, I attach to this submission a copy of my February 4, 1986 statement for your information. Suffice it to say that the H.R. 3838 proposals are potentially very damaging, and that, from what I have heard to date, the proposals about to be put out by the Senate Finance Committee for discussion do nothing to lessen that potential damage.

In these brief remarks, I have tried to emphasize my most important concerns from the point of view of a commercial banker. I felt that would be most useful to the committee in view of the essential role the commercial banks must play if the Baker initiative is to succeed. I strongly believe that it is clearly in the U.S. national interest to ensure that this program succeed, since the health of the developing world's economies is essential to our own economy,-- especially to jobs and income in the beleaguered U.S. export sector. Many institutions, public and private, will have to cooperate to bring about that progress, and I hope I have helped bring into focus what it will take to achieve the full cooperation of the world's commercial banks in this regard. It has, as you know, been difficult to coordinate the very large number of banks involved in

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international lending, and to convince them of the wisdom of the recommended policy. They can only be expected to assume further risk if they are convinced that the combined efforts of all players under the Baker Initiative will result in an improvement in the quality of the existing assets in their portfolios, and this can only happen through sound economic policy formation and implementation in the debtor countries. The Baker Initiative offers a means to achieve that.

Mr. Chairman, I would now be happy to try to answer any questions you or the other members of the Subcommittee may have.

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Chairman LUNDINE. Thank you very much, Mr. Clark.
Dr. Roett.

STATEMENT OF DR. RIORDAN ROETT, DIRECTOR, LATIN AMERICAN STUDIES PROGRAM, JOHNS HOPKINS SCHOOL FOR ADVANCED INTERNATIONAL STUDIES, AND CONSULTANT, CHASE MANHATTAN BANK

Dr. ROETT. Thank you very much, Mr. Chairman.

Let me, too, congratulate the subcommittee on its initiative, which is both positive and progressive.

Let me summarize very quickly some of the points I make in my written statement.

First and foremost, as the subcommittee recognizes, 1986 is a year of increasing unpredictability in the international environment and therefore, greater vulnerability for all of the players. The assumptions we all made in 1982 and 1983 about the debt crisis and about the particular roles that everybody would play, the private commercial banks, the multilateral institutions, the OECD governments, and the debtor countries, have all changed. These changes were not predictable 3 years ago, but they are now becoming reality and these new realities must move policy.

We are in a position now where the old damage limitation that the private commercial banks very successfully initiated in 1982 is no longer reasonable as a medium- and long-term policy for the United States, or for the debtor countries.

The new realities are the following:

First, increasing resistance to IMF conditionality. Therefore, we are moving toward using the World Bank in some way. We need to be very clear that the Peruvian Government, the Mexican Government, and others have made it known they will not accept traditional conditionality from the IMF and something must be found to take its place. Point one.

Point two, there are very new political realities in Latin America. The U.S. Government and the OECD countries must recognize that. Those new realities are summarized in one word—democracy. There has been a very strong return to democratic, civilian, political institutions in Latin America, very different from the environment in which the debt crisis opened in which many governments were run by the military in the early 1980's.

That is an important fact for us to understand in terms of the increasing social pressure within Latin America and the Third World to reject further austerity, which has been the hallmark of 1982–85, and to rekindle economic growth.

And therefore, this legislation's emphasis on growth is terribly important in terms of understanding the new political and economic realities in the hemisphere.

The living standard of Latin America has dropped precipitously since the early 1980's. New jobs must be created and new democratic governments must have something on which to base their legitimacy.

Thus, any institutional help, whether international or bilateral, is absolutely important.

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Third, a new reality—economics of adjustment and the need for growth. Quite clearly, growth is going to remain the major policy emphasis of all of the Latin American countries. The financial team in Brazil has made that point. Other governments have also selected the same priority in terms of their own development models for the rest of the decade.

The United States and the OECD countries must understand that the sharp drop in trade opportunities for Latin America, the continuing flight of capital, and the lack of new investment must be taken into consideration in looking at the next phase, phase 2, of resolving the international debt crisis.

It is important to remember that there has been a very sharp drop in direct foreign investment. From an average of $5.2 billion between 1977 and 1982, the figure has dropped to half that in 1983 and 1984. A great deal of capital has fled the region and the flight capital issue must be addressed by the Latin American countries. Any attempt to establish a policy where new bank lending, multilateral or private, would continue without recognizing the flight of capital would be unrealistic and politically unwise.

There has also been continued and increasing protectionism in the industrial countries. Your draft bill recognizes that and addresses it, I think, in strong terms.

We are also confronted with stagnant commodity prices worldwide, lackluster growth in the western European economies, and in 1986, the oil price shock. All of those, then, have impacted very negatively on Latin America and the Third World.

In recognition of that fact, we have the Baker proposal, a very welcome initiative that follows 3 years of adjustment and austerity, an initiative that recognizes the need for economic growth to deal with some of those social and political realities in the Third World.

It also emphasizes very correctly that Third World governments must undertake needed internal structural reforms that will correct more than a decade of poorly planned development decisions. But these decisions cannot be taken overnight. They cannot be implemented overnight. And it must be understood that those adjustments which are underway—if one examines the program of President Febres Cordero in Equador, the new Plan Cruzado in Brazil, the now 6-months-old Austral Plan in Argentina—represent democratic political leaders taking tough decisions.

We also need strong economic and financial support to allow those initiatives to go forward.

The Baker plan—redefining the role of the World Bank in particular—does again emphasize the importance of stressing growth in terms of the multilateral and bilateral relations between the United States and Latin America.

What is key here, it seems to me, is to identify the one main player that has not been assigned a specific role; that is, the Government of the United States and its industrial allies in the OECD framework.

The real key to the success of the Baker initiative and others in 1986, is bringing in governments to participate in the medium- and long-term resolution of the international debt crisis.

Clearly, the private commercial banks can only play a supporting role in the future. Banks must make decisions on the basis of the

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creditworthiness of their borrowers. With few exceptions, few Third World countries can honestly be classified today as credit-worthy.

However, it should be emphasized that private banks are ready to continue and are continuing short-term financing and trade financing. All the countries of Latin America have maintained their trade obligations in good order and are expected to continue to do so given the importance of exports in their recovery plans.

What is required is a recognition by the governments of the OECD, and the summit may well be the appropriate place to make that public policy. That policy, not private bank lending, is the key to successfully implementing a new game plan for phase 2 of the debt crisis.

As you state in your draft legislation,

> The Congress must act to provide a clear statement of U.S. policy on international debt management and trade liberalization and provide direction to the President and other executive officers of the United States in carrying out such policy.

You also correctly assert that policies aimed at increasing the effectiveness of the World Bank, a central actor in the new initiative, will "need the political support of the United States."

In effect, the subcommittee is calling for a new role for the Government of the United States and its industrial allies, a political role that involves public policy decisions.

Mr. Chairman, the subcommittee is totally correct in this emphasis. The OECD governments have failed to take direct action in addressing the debt crisis during the last 3 years. They must do so in 1986 and therefore, neither private commercial banks, nor multilateral financial institutions, are able to accept the full responsibility for resolving the complex dilemma in which we find ourselves.

One example, quite clearly, is that of interest rates. A major part of any solution for the debt situation is a reduction of the vulnerability of the debtor countries and their banks to a rise in dollar interest rates.

Interest rates, however, are under the control of neither the debtor countries nor the banks. As we well know, the level of dollar interest rates fundamentally reflects the fiscal and monetary policies pursued by the OECD countries. This is critical for all of us to remember. No solution will work unless something is done to reduce the interest rate vulnerability of the debtor countries. In large measure, interest rates are under the control of the creditor governments.

This suggests that any solution to the problem will need to explicitly address policies in the OECD countries to recognize their authority in establishing interest rate levels.

Mr. Chairman, that is a political decision. It is the way in which public policy needs to move in 1986 and beyond.

What is required is a new level of political coordination as we move forward. The World Bank has a fundamental role to play. The private commercial banks and the IMF also have roles to play. But to bring about government decisions in Latin America and the Caribbean to undertake severe, but needed, structural adjustment will probably require the political involvement of the United States and of its allies.

Why?

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Simply because the Latin American and Caribbean governments have redefined the debt as a political issue. They have begun to act and speak collectively and we must not underestimate the possibility of precipitate action by the Latin American States in a debtor's cartel, or moratorium if they don't receive a political response given the harsh economic and social realities outlined earlier in this statement.

I would stress before this committee, a point of which it is you are already aware. That is the growing sense of frustration on the part of the Cartagena Consensus Group organized by the Latin American States in 1984 to attempt to establish a position for Latin America and the Caribbean with regard to the debt question.

At their last meeting in early 1986 in Uruguay, the Group issued a communique which stated very bluntly,

> The Cartagena Committee concluded that, in the case of certain countries, notwithstanding their important efforts of national adjustment, a point has been reached at which the introduction of significant changes in current financial agreements cannot be delayed. These changes must be made particularly in regard to interest rates, so as to distribute in a more equitable manner between creditors and debtors the burden of the economic adjustment.

It is clear, Mr. Chairman, that there is a growing impatience on the part of the Latin American and Caribbean countries heightened by the drop in world oil prices, continuing protectionism and the inability to raise commodity prices worldwide, in addition to other economic realities in the world today.

That is, the Cartagena Group, which is a collective spokesman for the Latin American States, should not go unheard. It is making a political statement.

Finally, it's difficult to imagine that the private commercial banks, even the World Bank, will be able to reverse the current trend in some of our neighbors, particularly in Mexico. This clearly and increasingly is a national security issue for the United States and must be recognized as such.

Given the widespread societal malaise in Mexico, it will require much more than new bank loans, public or private, to deal with that issue. Only the United States Government, with the support of its industrial allies, are in a position to open negotiations and seek a political solution to Mexico's problems.

You cannot imagine that private commercial bank lending or even structural adjustment loans will resolve the internal inconsistencies and complexities of the current situation in Mexico, and I go into that situation in some detail in my testimony.

Finally, in conclusion, Mr. Chairman, the debt crisis, I emphasize once again, has entered a new phase of very heightened uncertainty. While the private commercial banks and the multilateral financial institutions need to play an important role, the debt is increasingly political and it has been defined as such by the Latin American, Caribbean and Third World countries.

The United States and the OECD must respond in increasingly political ways to the position taken by the Third World countries.

We may be moving in some cases toward government-to-government negotiations. Certainly, executive leadership in this country is needed to support the Baker initiative, a very welcome initiative

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and an important process, to supplement the drop in oil income and to induce structural changes in all the countries of the region.

It is in our national interest to stabilize the debt situation in Latin America. It is the great public challenge we face and it cannot be left totally in private hands. Only strong political leadership at the government level internationally defined will bring about the twin goals of economic growth and internal structural adjustment, in the long run, serving the interest of stabilizing democracy in this hemisphere and protecting U.S. vital interest in the region.

Thank you.

[The prepared statement of Dr. Roett follows:]

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Statement of Dr. Riordan Roett
Professor and Director
Latin American Studies Program
The Johns Hopkins School of Advanced
International Studies (SAIS), Washington, D.C.

Before the
Subcommittee on
International Development Institutions and Finance
of the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
March 18, 1986

Mr. Chairman, I very much appreciate this opportunity to appear before the International Development Institutions and Finance Subcommittee to discuss the current state of the international debt situation. The Subcommittee is making a critical contribution in holding this series of hearings. It is clear that the initiative undertaken by Secretary of the Treasury Baker in Seoul, South Korea is moving very slowly; it is also clear that the expectations of economic growth are increasing throughout the Third World, particularly in Latin America. The issue of the debt is no longer a question of finance, narrowly defined; it is a foreign policy question of the highest priority for the United States government. In my remarks, I will emphasize the interplay among the international development institutions, the private commercial banks and Latin America; it is the geographical area in which I have the greatest experience and it is clearly a region in which U.S. private commercial bank exposure is significant and in which the U.S. has the greatest security interests as they relate to regional stability and long term development.

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The Current State of the Debt Crisis

1986 is a year of increasing unpredictability in the international environment - and therefore, greater vulnerability for all of the players. The assumptions that were made in 1982-1983 with regard to the appropriate roles of the players in the international debt crisis - the private commercial banks, the multilateral financial institutions, the OECD governments, and the debtor countries - have all changed. Such changes were not predictable three years ago; but they are a reality today.

In 1982, a successful process of "damage limitation" was initiated by the private commercial banks with the endorsement of the International Monetary Fund (IMF) and the Federal Reserve System. The U.S. Treasury by and large supported the business-as-usual approach to the debt problem. IMF conditionality became the sine qua non for rescheduling Latin American debt. Through a series of complicated commercial bank-to-government negotiations, emergency measures, bridging loans and other mechanisms, the international financial system has survived the 1982-1985 period. But the widespread expectation, held in 1982-1983, that the indebted countries would reestablish their creditworthiness and return to the capital markets in 1985-1986 has proven incorrect. While much has been accomplished during the last three years, it is insufficient. New approaches are needed. New realities must be accepted. Key among those new realities are the following:

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1. Increasing resistance to IMF Conditionality.

One of the new realities is that the traditional role of the IMF is increasingly resented - and resisted - by the Latin American debtor states. The Peruvian government has refused to deal with the Fund. Brazil recently negotiated a new debt package without IMF involvement. Mexico, in its recent conversations with the private commercial banks, has indicated its unwillingness to accept further Fund conditionality. As part of the Baker Initiative, the IMF will return to its traditional balance-of-payments role for which it is well prepared. The Fund performed with efficiency and filled a void in the last three years; it can no longer do so given political opposition in Latin America and a sense at the Fund that it is time to move back from the front lines of the negotiation process.

2. New Political Realities in Latin America.

A fact of the utmost importance for the U.S. is the restoration of democratic government throughout the Western Hemisphere. Following years of military rule, Argentina, Brazil, Uruguay, Guatemala and other states have returned to competitive, civilian forms of government. But these regimes are under increasing social pressures to reject further austerity and rekindle economic growth. The living standard of Latin America has dropped precipitately since the early 1980s. Jobs need to be created, social programs expanded, and new opportunities created. To do so is essential to maintain democratic regimes which is in the best interests of the U.S. The Economic Commission for Latin America and the Caribbean reported recently that:

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> At present there are about 130 million persons living in poverty in Latin America and the Caribbean, and their number would increase to 170 million by the year 2000 if the style of development of the majority of the countries of the region is not changed.... by the end of the century, it is estimated that the poor will be concentrated in the cities - one of every four urban inhabitants would be destitute - where approximately 102 million of them would be living by then. The proportion would be even worse as far as the rural population is concerned: 50% of rural inhabitants would be under the critical poverty line. Although statistics show a reduction in the percentage of people living in poverty - 35% in 1980 as against 40% in 1970 - in absolute terms the mass of critically poor continues to grow.
>
> (CEPAL News, Vol. V, No. 7, February 1986, Washington Office of ECLAC, Washington, D.C.)

3. The Economics of Adjustment and the Need for Growth.

The restoration of democratic governments and the growing social pressures are directly related to the economic realities of Latin America and the Caribbean. The development models of the 1970s adopted by the region did not work, by and large. Growth was financed by increasing reliance on foreign capital. With the recession of 1980-1981, world trade declined and Latin American governments were unable to earn the foreign exchange required to both finance growth and to meet their debt commitments. Rising interest rates compounded the situation. Money borrowed at low rates in the 1970s, at variable terms, suddenly became increasingly expensive to repay.

Referring again to the United Nations Commission on Latin America and the Caribbean:

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> For Latin America, this evolution of international trade was extremely unfavorable. Because of the sharp decline in the international prices of most basic commodities, the terms of trade went down sharply and continuously between 1981 and 1983, recovered only marginally in 1984, and fell once again in 1985. In fact, over the five-year period 1981-1985 the deterioration in Latin America's terms of trade was over 16%. Had it not been for this drop, the countries of the region would have had some US$ 15 billion more in 1985, which, together with the trade balance (goods and services) of US$ 30 billion registered that year, would have made it possible to pay the interest on the external debt and at the same time increase the region's international reserves by some US$ 10 billion.
>
> (United Nations Commission on Latin America and the Caribbean, LS/L.371 (CEG.11/4, January 27, 1986, p. 13).

A sharp drop in trade opportunities was accompanied by a dramatic increase in real interest rates. That had the effect of adversely affecting the debt service payments and terms of trade. Interest payments now exceed the cost of oil imports in the developing countries. By increasing the cost of servicing the external debt, they enormously expanded the current account deficit and helped create a considerable transfer of real resources to the exterior. Latin America's gross remittances of interest payments rose at a dizzy pace from a little under US$ 6.9 billion in 1977 at almost US$ 39 billion in 1984, remaining approximately at the same high level in 1985.

Lost trade opportunities and escalating interest rates were accompanied by a reversal of financial flows. The net flow of bank credits to the region, which had amounted to US$ 11.4 billion in 1982, was practically halved the following year and actually became negative in

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1984 and the first half of 1985. In the last 18 months (Argentina and Brazil excepted), the absolute level of the accumulated credits granted to the countries of the region, taken as a whole, went down by almost US$ 500 million. In sharp contrast, payments of interest and profits to the exterior from Latin America has continued to fluctuate closely around an average of some US$ 36 billion per year throughout the period.

Other factors that negatively impacted on the region were:

-- a sharp drop in direct foreign investment. From an average of US$ 5.2 billion between 1977 and 1982, the figure went down to half this level in 1983 and 1984.

-- a considerable increase in flight capital. As Morgan Guaranty's World Financial Markets recently reported:

> ...most of the new money loaned to Latin America in the past three years - by private creditors, involuntarily - can be viewed as having facilitated additional flight capital. In the three years ended last September, nor bank residents of the ten debtor countries added $15 billion to their identifiable bank deposits abroad, bring the total to $55 billion. Even this probably represented only about half the overall amount, other than official reserves, invested overseas by residents of debtor countries - in bank deposits, securities, real estate and direct investment.
>
> (Morgan Guaranty Trust Company of New York, World Financial Markets, February 1986, p. 3.)

-- continued, and increasing, protectionism in the developed countries.

-- stagnant commodity prices worldwide.

-- lackluster growth in the western European economics.

-- and, in 1986, the oil price shock.

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The Baker Initiative

By the end of 1985, these economic realities were obvious to those who understood the mood in Latin America and the Caribbean. After three years of adjustment, which succeeded in sharply reducing the current account deficit, growth has become a necessity. And the key to the Baker Initiative is growth with structural adjustment. Third World governments must undertake needed internal reforms that will correct a legacy of decades of poorly planned development decisions. It is clear that these reforms cannot be initiated overnight; they will vary from country to country. And it should be stated very clearly that the people of Latin America appear to understand the need for structural adjustment perhaps better than their political leaders - the Plan Austral in Argentina and the Plan Cruzado in Brazil, which represent severe programs of structural adjustment - have been met with widespread popular support. Public opinion polls in Venezuela indicate that the people of that country are willing to support reform measures if they will bring economic stability and opportunity in the future.

The Baker Plan redefines the role of the World Bank, particularly, in dealing with the necessity of growth. It assigns a supporting role to the private commercial banks, as well. And it builds the case for the Plan on the need for internal reform in the debtor countries. The main players not assigned a role are the governments of the industrial countries. That, Mr. Chairman, I would argue, is the real key to the success of any initiative as we enter the next phase of the debt crisis in 1986. Why?

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Clearly, the private commercial banks can only play a supporting role in the future. Banks must make decisions on the basis of the creditworthiness of their borrowers. With few exceptions, few Third World countries can honestly be classified as creditworthy. However, it should be emphasized that the private banks are ready to continue - and are continuing - short-term financing and trade financing. All the countries of Latin America have maintained their trade obligations in good order and are expected to continue to do so given the importance of exports in their recovery plans.

What is required is a recognition by the governments of the OECD countries that public policy, not private bank lending, is the key to successfully implementing a new game plan for phase two of the debt crisis.

As you state in your draft legislation, "the Congress must act to provide a clear statement of United States policy on international debt management and trade liberalization and provide direction to the President and other executive officers of the United States in carrying out such policy." You also correctly assert that policies aimed at increasing the effectiveness of the World Bank, a central actor in the Baker Initiative, will "need the political support of the United States." In effect, the subcommittee is calling for a new role for the government of the U.S. and its industrial allies - a political role that involves public policy decisions.

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Mr. Chairman, the subcommittee is totally correct in this emphasis. The OECD governments have failed to take direct action in addressing the debt crisis during the 1982-1985 period. They must do so in 1986. Neither private commercial banks nor international financial institutions are able to accept the full responsibility for resolving the complex dilemma in which we find ourselves.

One example is that of interest rates. A major part of any solution for the debt situation is a reduction of the vulnerability of the debtor countries (and their banks) to rise in dollar interest rates. Interest rates, however, are under the control of neither the debtor countries nor the banks. As we well know, the level of dollar interest rates fundamentally reflects the fiscal and monetary policies pursued by the OECD countries, particularly the U.S. This is critical to remember. No solution will work unless something is done to reduce the interest rate vulnerability of the debtor countries. And in large measure, interest rates are under the control of the creditor country governments. This suggests that any solution to the problem will need an explicit policy response by the OECD countries to recognize their authority in establishing interest rate levels. Mr. Chairman, that is a political decision; it is the way in which public policy needs to move in 1986 and beyond.

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What is required is a new level of political coordination as we move forward to seek new policy responses to the debt crisis. The World Bank has a fundamental role to play and your draft legislation indicates how - and why - the Bank must act with vigor. The IMF will continue to play a role. The private commercial banks, as needed and as is feasible, given established norms for responsible credit decisions, will continue to be involved. But to bring about government decisions in Latin America and the Caribbean to undertake severe but required structural change will need the involvement of the U.S. government and its OECD allies. Why? Simply because the Latin American and Caribbean governments have redefined the debt situation as a political one. They have begun to act and speak collectively and we must not underestimate the possibility of precipitate action by the Latin American states - a debtors cartel or a moratorium - if they do not receive a political response given the harsh economic realities I have outlined earlier in this testimony.

The Cartagena Consensus Group

In response to the dramatic fall in the standard of living in Latin America, and the increasing burden of debt repayments in 1984, the major Latin American states banded together to form the Cartagena Consensus Group. That group has issued a series of reports - and warnings - from 1984 to 1986. In the most recent meeting, held in Punta del Este, Uruguay, in February 1986, the group issued a communique which stated that:

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> The committee concluded that, in the case of certain countries, notwithstanding their important efforts of national adjustment, a point has been reached at which the introduction of significant changes in current financial agreements cannot be delayed. These changes must be made particularly in regard to interest rates, so as to distribute in a more equitable manner between creditors and debtors the burden of the economic adjustment.

It is clear, Mr. Chairman, that the Cartagena Consensus Group is increasingly frustrated. The recent fall in world oil prices, which caused the meeting in Punta del Este to be convened, has had a dramatic impact on the economic growth possibilities for Mexico, Venezuela, and Ecuador. But is is more than oil prices. It is the accumulated effect of three years of austerity. And it is the recognition by civilian governments that a strategy of growth is now required.

Political Leadership

But the leadership and ultimately, the financing to induce both growth and structural change will require OECD government leadership. As your draft legislation states, for example, the President of the U. S. must take the initiative with other member nations of the World Bank to amend the Articles to change the institution's gearing ratio. It is to the President and the Treasury Secretary, and other appropriate government officials, that we must look for bold and imaginative leadership on trade policy, monetary reform, and related matters. And it is to the President and his chief advisors that we must look for political leadership in the diplomatic efforts that will be required to

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convince some countries in the hemisphere to undertake the internal decisions needed for adjustment measures. A case in point is Mexico.

It is difficult to imagine, Mr. Chairman, that the private commercial banks, or even the World Bank, will be able to reverse the current trend in neighboring Mexico. Clearly, the issue is political - a lack of political leadership and a widespread societal malaise that will require more than new bank loans - public or private. Only the U. S. government, with the support of its industrial allies, are in a position to open negotiations and seek a political solution to Mexico's problems. And it is essential, in the case of Mexico, that we do so as quickly as possible. The 2000-plus mile border makes Mexico a domestic political concern for the U. S. Illegal immigration is increasing; Mexico is now the principal conduit for the marijuana and cocaine that enter the U. S. There is no new investment by the private sector; Mexico remains heavily dependent on oil revenues to both finance needed imports and its foreign debt. But those revenues have and will continue to fall, if current market trends are accurate. The Mexican political system appears to be in an advanced state of disarray, also. Fraudulent elections at the state level in July 1985 may well be repeated in July 1986. President Miguel de la Madrid appears and acts as a lame duck chief executive only half way through his six year period. Surely, those realities add up to an argument that Mexico is now a national security concern for the U. S. and its allies. It is no longer a matter for the market place. It will require immediate and effective political leadership by the President and the Secretaries of State and Treasury.

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Conclusion

The debt crisis has entered a new phase of heightened uncertainty. While the private commercial banks and the international financial institutions will need to play an important role, the debt is increasingly defined in political terms by the governments of Latin America and the Caribbean. That requires a political response - and it must come from the President of the United States and his allies. Government to government negotiations may be required. Certainly, executive leadership will be needed to support the Baker Initiative, to supplement the drop in oil income for the petroleum-exporters, and to induce structural changes in all of the countries of the region. It is in our national interest to stabilize the debt situation in Latin America and the Caribbean. It is the greatest public challenge we face. And it cannot be left in private hands. Only strong political leadership will protect American interests in the region and forestall a climate of polarization and confrontation. The twin goals of economic growth and structural adjustment, in the long run, serve the interests of stabilizing democratic regimes in the Western Hemisphere, and protecting U. S. vital interests in the region.

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Chairman LUNDINE. Mr. Torres.

Mr. TORRES. Thank you, Mr. Chairman. I certainly welcome the comments by both gentlemen, especially the much more detailed report that Dr. Roett has just indicated.

Mr. Baker's initiative, as Mr. Clark pointed out, and you as well, sir, did take on a point in New York not too long ago in beginning to coordinate some attitudes by the Group of Five to begin to work on exchange rates, to begin to deal with the question of lowering interest rates.

We see that today. Just today I looked in the press and there's already a declining value of the dollar and that's having an impact on some trade matters.

But you mentioned, Dr. Roett, in your closing comments here, about the political leadership, the will that is needed by both Governments and, in emphasis, our own government, to begin to deal with these questions in the hemisphere.

Specifically, what would you suggest? You say we need strong leadership. Are you talking about the Baker initiatives, following through on them, or additional inputs?

Dr. ROETT. I think, at least from my point of view, we're talking certainly about supporting the process begun by the Secretary in Seoul, but going far beyond it as you are attempting to do with this draft legislation. That is, initiating a process where the World Bank begins much faster disbursal of loans, where structural adjustment becomes a reality now and not in the future, in which we really do redefine the role of the Inter-American Development Bank as well as the World Bank. And I would argue, Mr. Congressman, that with regard to certain countries, Ecuador for example, where the President has taken all the tough decisions in the very early phase of a new democratic government and has now been hit hard by the oil prices, should we not be looking for a particular kind of response. A special package, but a variation of what we're talking about here today to make sure the Ecuadorian Government survives.

In the case of Mexico, a very different approach is needed. That would have to be a White House to Mexico negotiation on what it is we see as our vital interest in that country, within the framework of the bilateral relationship. An effective proposal should use parts of the Baker initiative and parts of the other suggestions being made by this committee to put together more than a momentary response or a 1-year program, a much longer program which would be really an historical breakthrough, but in terms of our relationship to Mexico, I think we have no choice but to begin to look that way.

Mr. TORRES. You don't feel at this time that there's been enough emphasis on a bilateral basis to deal with these questions with Mexico?

Dr. ROETT. I do not. I believe that the Mexican situation has deteriorated very badly and that we have moved far beyond the possibility of private commercial bank lending solving that question, nor can we leave it to the international financial institutions.

We're dealing here with a much higher political question, a national security question.

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Within that framework, it seems to me, the private commercial banks and the multilateral institutions do have a role. But that is a very special case that must be defined in a very special way.

I would argue a need to look at each country much more carefully than we have during the 1982-85 period because all have different resource bases; they all have different social and political problems. But all clearly now are moving increasingly toward emphasizing growth. The United States and its allies must move to respond institutionally as quickly as possible to make sure that the Cartagena frustration does not grow and become a different kind of political problem for the United States and our allies.

Mr. TORRES. There's talk of late of perhaps imposing an import tax fee on oil. What effect would this have on Mexico relative to this kind of situation?

Dr. ROETT. Well, I guess it would depend on what we did with the revenue from the import tax. Some have suggested imposing an import tax and putting a large share of that revenue into a development fund. That kind of imaginative thinking would help domestic policy both in terms of maintaining reasonable prices for gasoline at the pump, but also in routing enough of the money into development efforts to support U.S. security objectives in the hemisphere.

I think such proposals illustrate the way we need to move in the future to find the kinds of moneys required to support growth strategies if, indeed, there is a willingness on the part of Latin governments to undertake internal reform

For example, if one looks at, as I quote in my statement, the flight capital coming out of Mexico, only Venezuela is classifiable as the capital of flight capital after Mexico. And it does not make much sense for private commercial banks or for multilateral institutions to pour more money into Mexico when it's going to turn around and come back out again.

That, though, is a political question. You can't expect a private commercial banker or the president of the World Bank to really cut the political deal that's required to begin to turn around those kinds of policies.

There has to be, it seems to me, a much different political set of negotiations with a country like Mexico.

Mr. TORRES. Thank you, sir.

Mr. Chairman, I yield back the balance of my time.

Chairman LUNDINE. Mr. Bereuter.

Mr. BEREUTER. I will pass on this round, Mr. Chairman.

Chairman LUNDINE. Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

In his statement—I assume you made this statement.

Chairman LUNDINE. Yes; I did. I read it just exactly like they wrote it for me today. [Laughter.]

Mr. MCCANDLESS. We all want to start on a level playing field. The chairman talked about the National Bank Act and what might be needed in the way of changes. Having also been in Seoul and been involved in the process and seeing some light at the end of the tunnel with the Baker initiative at its beginning point, we come back to the point here of the private sector and its part in what the Baker initiative's ultimate intent is and the reluctance on

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the part of the private sector to want to get involved in some kind of an insurance beyond that that they currently have, in that the portfolio would simply not be expanded with the same risk, or even more risk, but that the portfolio would have a certain amount of stability if we were to extend credit under this concept.

Let me throw this out at you.

Most of these loans that we are talking about for major institutions deal with more than 700 banks with some type of structure within the banking system.

It would appear to me that we've reached a point in this process where we are talking about an enormous number of people being involved but not really having an excellent way of handling basic policy and combining that with the original intent of being both privately and publicly involved.

And with all of that, it may sound like I am interested in a lot of things of an organizational nature, but let me throw this out to you gentlemen.

As a means of encouraging the private sector to become more involved at this point in the system, a private sector holding corporation that has nothing to do with the World Bank or the development scene, where these companies were to buy shares in this. The shares would permit some type of voting procedure and that this would be the basis upon which then further private institutional lending would take place under whatever plan we're going tobe talking about. And that is, part of the inducement to buy the shares that this private holding company or corporation, whatever we're going to call it, would become somewhat self-insured, a spin-off of the FDIC and FSLIC, something like that, with possible government participation in that aspect of it.

Is this a direction that one might want to explore? Mr. Clark.

Mr. CLARK. Mr. Chairman, can I comment on this?

Chairman LUNDINE. Oh, yes, please.

Mr. CLARK. Well, you know, we're up to our eyeballs in country debt. We would love to have somebody else help us to share the risk, particularly as we move into new lending, which is what the Baker proposal calls for.

You've got two possibilities, I think. One is sharing it in the private markets. You have a lot in your legislation about the development of capital markets and you used the word "securitization," I think, which is a good word.

We're trying everything we can think of. We've even turned to the insurance companies. We had a policy for a minute which let us spread some of our risk through the insurance industry, but the insurance industry decided that they didn't want to get very involved in that.

So you really are left, Congressman McCandless, with the idea of whether we look to the public sector for some kind of support, and you indicated that in your comments.

That's a tough one. You're between a rock and a hard place. You want the banks to increase their lending, but do you want to have it done with some kind of public support?

There are at least two broad issues there. One is the broad issue of bailing out the banks. I testified a lot during the go-arounds with the IMF quota increase, and we may be back testifying in the

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future for a World Bank increase. A lot of your peers look on that strictly as an effort for us to get the public sector to bail us out.

We don't want to be in that position. We've got this exposure and we're prepared, and we think we are working our way through it.

So any suggestion that the public sector would get involved immediately gets us into this issue and we don't want to go near it because we think we're going to be able to work our way through it. We think we're about halfway there now. We are 3½ years after the crisis of August of 1982 and we think we're about half way out of the debt problem.

Even the Baker initiative that we are talking about, we are saying that we are prepared to put up $20 billion of new money and that is going to be 100 percent on our risk.

Mr. McCANDLESS. Let me interrupt you. We, the United States, is $7 of that $20. Thirteen dollars would come from institutions other than the United States.

Mr. CLARK. Not the $20, sir. The $20 is the commercial bank component.

Mr. McCANDLESS. The United States would be $7 of the $20.

Mr. CLARK. United States banks.

Mr. McCANDLESS. We're talking about $20 and all of a sudden, everybody says, well, the United States is going to put $20 billion more back in. The initiative says $7 from the United States and $13 from——

Mr. CLARK. Seven dollars from the U.S. commercial banks.

Mr. McCANDLESS. Yes; and $13 from other lending institutions throughout the world.

Mr. CLARK. Yes. I was talking about the global commercial banking system.

Mr. McCANDLESS. I see.

Mr. CLARK. That's 100 percent on our risk. We are not looking to anybody else to cover us.

Mr. McCANDLESS. Well, as the Secretary has said, if it isn't a good deal, I don't want you to get involved.

Mr. CLARK. Yes, right. [Laughter.]

The Secretary did say that. [Laughter.]

Mr. McCANDLESS. And one had to smile a little bit based upon your current portfolio.

Mr. CLARK. That's right.

Mr. McCANDLESS. If it isn't a good deal, you're not going to participate. So what I'm looking at is a way by which it becomes a good deal. That's the reflection I was trying to get.

Mr. CLARK. We really—when we think about making it a good deal, though, Congressman, we want everybody to know that we aren't thinking of it in terms of some kind of a public sector guarantee on it. That's not what we're looking for.

What we hope to do is to be able, under the structural adjustment loans and so on, to develop sufficiently good programs at the country level so that a country is relatively more creditworthy than it was before.

Mr. McCANDLESS. Did you have something?

Dr. ROETT. A quick comment, Mr. Congressman. Yes; I think the point that Mr. Clark makes in terms of risk is very important, and in terms of private bank exposure.

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One of the attractive issues that is not raised, therefore, it's attractive, in this draft legislation is that we have now moved away from an earlier phase of attempting to bash the banks and blame the commercial banks for the debt crisis. We're now moving into a much more advanced and forward-looking set of strategies in which your suggestion certainly is one that is very welcome. But I think Mr. Clark's point is very well made that the private commercial banks do not want a public sector guarantee. They would hopefully look at themselves as one of a number of actors in a very different framework for resolving this issue in the future.

The key question for the private commercial banks, must be creditworthiness, given their domestic constituencies and the regulatory environment, and that is the key issue for any private commercial bank in looking at its future participation.

I think the Congress wants sound private commercial banks that have international as well as sound domestic operations. And whatever can be done in an uncertain environment to protect that soundness and their creditworthiness is key to any program working out over the next 3 to 5 years.

Chairman LUNDINE. If I can interject just one cautionary comment.

While I agree with the testimony of both witnesses, let's not delude ourselves. If we take some kind of a Third World debt legislation or a general capital increase to the floor of the House of Representatives, there's only one thing that would be a sure bet, and that is that bank bailout will be discussed.

Dr. ROETT. Yes; that's right.

Chairman LUNDINE. But what you're saying is not that we won't be accused of it, but that it won't be an intellectually fair charge as long as the banks have come forward with additional capital at their own risk.

Am I interpreting you correctly?

Dr. ROETT. Commitment by the private commercial banks is clear and straightforward; it is buttressed with the same argument made by the Secretary in Seoul that our participation, public or private, in this country, or the other OECD countries, depends upon certain policy responses from the debtor countries. And that is the basic sine qua non of where we are now going in the future.

That's why I raised earlier the political question in terms of the United States and Mexico and some of those other very important structural issues that need to be addressed in the foreign policy framework.

I don't think you or we want private commercial banks making U.S. foreign policy. That isn't the job of the private commercial banks or of multilateral development institutions. That, therefore, is a political responsibility of the executive with the participation of the Congress.

Mr. CLARK. Congressman Lundine, could I comment on that? Do you mind?

Chairman LUNDINE. Yes; please do.

Mr. CLARK. I was in Cairo last week. If any country is in a desperate situation, it's Egypt. They're important friends of ours and we'd like to have Mr. Mubarak get through this. They've just had riots. They killed 107 people out there by the pyramids and so on.

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Senator Mathias came through just a couple of days before I did. He met with Mr. Mubarak. And he said, you know, I am sorry, but whatever Egypt does today, you are going to have to do it on your own. We provide a substantial amount of assistance, but it is going to be reduced. We have something in the Congress called Gramm-Rudman. You just can't look to the United States to provide additional funding under these circumstances. We've got sort of a deficit problem in our own country.

I am a little worried that Mr. Roett's statements might be interpreted by countries that are only too anxious to interpret them, that there may be substantial public moneys available on a bilateral basis to patch over these situations.

Maybe I don't get the flavor right of his comments, but Mexico is on our border. We share a big border with them. We're terribly anxious that the de la Madrid Government do well and so on.

But is he suggesting that there might be large public moneys available to deal with this problem? And if that's the case, do I misread Gramm-Rudman?

Dr. ROETT. My position is that what is available may well need to be packaged very differently. Rather than allowing, in a sense, the market place to drive what different institutions do with regard to Mexico, one needs to have a much different set of priorities and not let the market determine what happens.

I think there is a growing sense in the Congress, as well as in the executive branch of the United States, that Mexico is a very particular and a very difficult problem for us, not comparable to Argentina or to Chile or to Brazil precisely because of that border.

Recent newspaper headlines indicated, for example, a dramatic upsurge in illegal immigration. Mexico last year once again became the largest exporter to this country of marijuana and heroin. There are very serious bilateral problems that, in my mind, at least—Mr. Clark may not share this—distinguish Mexico from the other debtor countries, precisely because it is such an American problem, a North American problem. We therefore cannot talk about Mexico in the same way we do other debtor countries, whether they be Egypt or Brazil or Argentina.

But the key to that is, as I said earlier in my testimony, not throwing good money after bad. As the flight capital data indicates very clearly, what is going into Mexico is turning right around and coming out again. So I certainly am not advocating more and larger amounts of money. What I'm arguing is a redefinition of the way in which what is available for Mexico is, given to Mexico and that certain political commitments be made by the leadership of that country in terms of necessary internal structural economic and political changes.

Mr. MCCANDLESS. Can I just ask—one quickie?

Chairman LUNDINE. Sure.

Mr. MCCANDLESS. You took a little bit of my time.

Chairman LUNDINE. Yes; I did.

Mr. MCCANDLESS. Thank you. The public financial institutions—the World Bank, development banks—in your gentlemen's opinion, is there adequate coordination between these to accomplish or achieve an ultimate objective in the area in which we are speaking?

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And throw in any other public institution you want that has something to do with the financial question.

Mr. CLARK. I would say, Congressman McCandless, that basically there is. I mean, we know what the limits are of the World Bank, what they can do within their charter. We know what the IMF can do. We know what the Inter-American Development Bank can do.

We spend a lot of time together. I think there's very good cooperation.

As I say, I just came back from Africa. I really wish I had the time to go through with you the things that we're doing in Morocco and Zambia. I mean, the World Bank is in there with structural adjustment loans. The Monetary Fund is in there with their balance of payments criteria, exchange rate and so on. And the commercial banks are in there with new money. We're making new loans to those countries right now, entirely outside the Baker initiative because they're countries that are performing well.

Now, there are other cases where the cooperation hasn't been as good. But I would say, by and large, today, under the pressures of the debt problem of 1982, we have gotten to know each other pretty well. [Laughter.]

Mr. MCCANDLESS. Thank you. Thank you, Mr. Chairman.

Chairman LUNDINE. Did you want to comment?

Dr. ROETT. Just a quick comment, Mr. Chairman.

I think all of us expect an increasing degree of efficiency and a higher level of problemsolving with the appointment of the new World Bank president, a very welcome appointment by the President of the United States of a highly competent former Member of this House, Mr. Conable. It has been of some concern to those who have watched the development process that the World Bank has been somewhat sluggish during the last couple of years in terms of responding.

That pace has now picked up in the new environment of the Baker initiative and, of course, with the current situation in many of the Third World countries.

So that in terms of the World Bank itself, the more efficient it becomes, the better is the exchange between it, the private commercial banks, and the International Monetary Fund.

So we look forward, as your legislation, again, suggests, to having a report on the World Bank, updating where the World Bank is in terms of its mission, its function, and how it sees itself under new leadership relating to the private and public institutions at the present time.

I believe the record in the past has been spotty. From my point of view, I think it's going to get much better both under the pressure of events in the Third World and, as we now move into a different level of executive direction and leadership in a different political environment in 1986. With Mr. Baker at the Treasury, this climate differs from 1982 or 1983, where much of our time had to be spent in damage limitation and putting out fires.

Mr. MCCANDLESS. Thank you.

Chairman LUNDINE. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Gentlemen, thank you very much for your testimony. I certainly share your enthusiasm, Mr. Roett, for Barber Conable's appoint-

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ment to be the president. I think working in conjunction with Secretary Baker, we can expect good things in our attempting to cope with a very difficult situation.

Mr. Clark, you made two statements that I wrote down. We're halfway out of our debt problem. We're not asking for help.

Are you free to tell me in what Caribbean and Latin American nations you have your greatest debt, your loan exposure at this point?

Mr. CLARK. Well, we are very heavy in Brazil, Argentina, and Mexico, the big three. We have exposure in all of the other countries in Latin America, significant exposure.

Mr. BEREUTER. And you can still make that statement with respect to Mexico?

Mr. CLARK. Yes, sir. Do you mind if I take a minute to explain why?

Mr. BEREUTER. I want some reason to have an optimistic point of view.

Mr. CLARK. Right. Exactly. [Laughter.]

I'm very happy to have an opportunity to do that because I know exactly what you have in mind.

What's happened over the last 3½ years, Congressman, and the reason why I make my statement is this. We basically have struck a deal with the developing countries. We have agreed to basically not collect any of our principal. We're making transactions where there is 7 years' grace period and then 7 years' pay, you know, that sort of thing. And as a result, our exposure in the developing world over the last 3½ years has remained just about flat in dollar terms.

So we basically haven't collected any of that. We haven't made much in the way of new loans, either, so it's basically been flat.

The other side of the deal has been that the developing countries, by and large, pay the interest on that debt at current market rates. And it is surprising how few exceptions there are. I mean, Peru isn't doing it and the Sudan isn't doing it.

But, by and large, the countries are not paying principal, but they're paying interest, religiously, currently at market rates.

Now, in 3½ years, that amount outstanding is, relative to everything else in the world, is way down. The capital base of the banks have more than doubled in the last 3 years. Our general loan loss provisions, depending upon the banks, are up very substantially. Even the exports have grown substantially.

So in relation to their debt servicing ratios, the thing has improved substantially.

Mr. BEREUTER. Throughout history, though, Mr. Clark, I want to know past this drop in crude oil prices, isn't the situation going to be extraordinary for Mexico?

Mr. CLARK. Well, OK. I was talking about the general systemic thing. And what I would say there, just by way of conclusion, another 3 years and these outstandings are going to be pretty small in terms relative to other things. That's progress of a kind.

Now, Mexico. OK. Mexico is a very special situation. They are hard hit by the petroleum thing. There's no question about that. They are helped by the drop in interest rates. Nobody reminds us of that, but the interest rate helps them enormously.

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But the problems they have, they have the deficit of the public sector, as a percentage of GNP, was running about 10 percent of GNP. That was before the earthquake and it was before the drop in the oil prices.

Now, you know, the Government is basically spending way beyond its means. They're printing money to cover the deficit and so on. And there isn't very much that the rest of us can do about that. They've got to address those problems.

That's where the structural adjustment loan and the IMF-type program comes in.

And there are a lot of discussions going on right at this very moment and we're hopeful that we will be able to put together a package for 1986.

Mr. BEREUTER. I don't see any reason for optimism, though, because Mexico and Central America and especially the Caribbean nations have so fundamentally been resistant to IMF kind of leverage. And now to suggest that we're going to begin to do this for structural changes from the World Bank, supply side arguments aside, not even thinking about them, but just their opposition to leverage. We have had two dramatic changes, one relatively major, the other certainly unprecedented in dropping income.

Mr. CLARK. You know, people were saying the same thing——

Mr. BEREUTER. Why should we expect Mexico is willing to make this kind of domestic reform to which Mr. Roett made reference a minute ago?

Mr. CLARK. The financial crisis started with Mexico in 1982. It's precisely the de la Madrid, Silva Herzog, Miguel Montserra team that have already demonstrated their ability to deal with this type situation.

Mr. BEREUTER. That looks like a minor bump on the chart compared to what's happened now. To me, at least, it looks like it.

I just don't understand how Mexico can possibly cope with that.

Mr. CLARK. Well, you know, they are still earning $7 billion this year in oil, in spite of everything. They hit a peak of oil earnings in 1981 and 1982, but $7 billion of oil earnings are more than they earned in oil 10 years ago. They had a nice ride up, but it didn't last.

Mr. BEREUTER. They have also accrued incredible debt since that time, too.

Mr. CLARK. Yes.

Mr. BEREUTER. I would estimate that their debt structure is substantially worse than it was when they were making a lower income.

Is that true?

Mr. CLARK. Well, certainly, the debt level is very much higher than it was 10 years ago. That's the case. But the cost of the debt is substantially less than it was in earlier years.

You remember the interest rate on the debt was getting up to 15, 16 percent per year and it's been cut in half now.

Mr. BEREUTER. Well, I'm just trying to find out why it exists, because we certainly don't have anything to offer in the way of financial assistance, despite the billions that we spend on foreign aid in Mexico.

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I say that for effect because we don't spend billions in Mexico and my constituents occasionally ask me about the billions we're spending in Mexico on foreign aid. We don't, of course. We didn't send any aid——

Mr. CLARK. I don't think you do have a lot to offer. I think it's kind of misleading to say that the Mexican debt is going to be politicized and America is going to somehow offer some additional assistance.

Mr. BEREUTER. Of course, until the Mexico earthquake aid, we weren't providing any direct, garden-variety, foreign assistance to Mexico. I think it's occasionally helpful to have Senators who are not running for reelection like Senator Mathias that can spread a little truth.

Mr. CLARK. I do, too. It was a very constructive thing that he did in Cairo, and the Government interpreted it constructively.

Mr. BEREUTER. Egypt, of course, is the second largest recipient of foreign assistance. We're not going to increase foreign aid——

Mr. CLARK. But it's dropping.

Mr. BEREUTER. We're not going to increase contributions to the MDB's. It's impossible in this kind of environment to do that. And it appears it's impossible to cut back on 50 to 55 percent of our total aid going to Egypt and Israel. So that doesn't leave any room for creativity from the point of view of foreign assistance.

So, Dr. Roett, when you speak of a package of assistance, can you be a little bit more specific, how we can assist Mexico to help itself, for example?

Dr. ROETT. Certainly, Congressman Bereuter. The American Banker reported recently that the recent decline in interest rates will help the Latin American debtor countries next year. The economic force that will most affect them this year is the collapse of the world oil prices.

What I'm arguing is, as you stated yourself, that the Mexican situation is a very dangerous one and a very difficult one.

Again, my argument is very clear and I want to make sure that Mr. Clark does not misrepresent me here. I am not asking for large amounts of new moneys to be tossed at Mexico. In fact, my argument is rather different, that we have sent a great deal of money into Mexico that then comes out illegally.

What I'm calling for, is a redefinition of the United States relationship with Mexico in which what is available is coordinated through both private and multilateral institutions. That was the key thing I said. Let the record state that is what must be repackaged in a political foreign policy context.

I think to walk away from the Mexican case and to argue that things are going to get better because they were worse is not relevant for policymaking. Nor would I make this argument for Equador, nor for Argentina. But if you look at the data once again and what the relationship between the Mexicans and the Americans is today, it must—it must—create a cause of concern in the Congress and in the White House. There is no question that concern is rising.

What I'm saying, then, is that as we now move forward to implement the Baker initiative, as we look at a new role for the World Bank, as we redefine, hopefully, the role of the Inter-American De-

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velopment Bank, and within that, the role of private commercial banks, European, Japanese, and American, that we understand business as usual with Mexico is not good business because the 3 years of adjustment in Mexico were not successful.

A lot of it was done with mirrors, as far as I am concerned, and for U.S. policymakers to go on believing the same mirrors will work for the next 3 years is n t, again, a good basis for policy.

So, not large new amounts of money. In fact, probably less money. But the amount available must be better used, or I would raise the issue that we should not be doing anything, as I am very conservative on this issue. However, we should be prepared for a possible crisis in United States-Mexican relations if we don't do anything by the end of this decade, given present trends which have been noted by both Mexicans and other observers.

Mr. BEREUTER. It's been a long time since Seoul and it seems to me that the reaction from the OECD and from financial institutions in this country and elsewhere have been rather cool to the Baker initiative.

I'm wondering how much life is left in this initiative. And perhaps you could explain to me why the reaction from OECD has not been more supportive.

Dr. ROETT. Well, I'd make a few comments, Mr. Bereuter, that, on the one hand, we need to look at the growth rates in Western Europe. Also, the levels of protection. That is, the economies of Western Europe are not the most dynamic within the OECD. There are real reasons why the OECD governments have not yet taken a more positive stand, although they certainly have been supportive of the Baker initiative.

And given the structure of debt, it is probable that the Western European countries look to the United States for leadership in this regard. And given their own internal dynamics, the private-public mix in terms of Western European participation in the Baker initiative, they, too, have been waiting for a redefinition of World Bank direction.

I was in Europe just 2 weeks ago before the President's announcement, and they were very concerned about where the Bank was going. From their point of view, it was floundering in many areas.

This, I think, will help a great deal to focus their attention on international giving and on the role that the United States and its partners can play using the World Bank, as the Secretary indicated, as a key cutting edge for the initiative.

Mr. BEREUTER. Thank you, Mr. Chairman.

Gentlemen, thank you for your testimony, your answers.

Chairman LUNDINE. I would like to get back to the Mexico issue.

Mr. Clark, it is true that they and other countries have met their interest rate obligations. But it is also true that there have been a number of sacrifices made by the average people in Mexico. What I—in your very optimistic outlook, what I wonder is how long you think that average people are going to put up with reductions in their standard of living so that they can pay U.S. banks.

Mr. CLARK. Very good question, Chairman Lundine. You know, the general perception around is that if you service our debt, it is going to take resources away and you aren't going to be able to

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achieve economic growth. But, you know, that's really not accurate. Let's take the case of Brazil today.

Brazil is absolutely current on its debt and it had the highest rate of economic growth of any one of the developing countries. Korea is another example. Korea has a lot of foreign debt. It services its debt regularly and grows because the debt has been invested in productive—you know, we think of debt somehow as a negative. But if debt has been properly used, it's an engine for economic development.

Now, the trouble with Mexico is not that they have a lot of foreign debt. The problem with Mexico is that they have all kinds of domestic distortions so that the money doesn't get invested properly.

And those domestic distortions are things that we, as very anxious to help them, there's very little we can do about it. And that's where the structural adjustment loans come in. That's where they go in and they say, you know, more debt won't help you if it doesn't get into the productive elements and so on. And we haven't had enough of those programs in Mexico.

But the problem is not with the foreign debt or the fact that it's being serviced. The problem is what use have they made of it.

In the case of Mexico, to this day, they still have a very high rate of inflation. We can't solve that problem. The Mexicans have got to solve that problem. And as long as they have a high rate of inflation, it is worth more for them to buy dollars and wait for the next devaluation.

Until the Mexicans deal with those problems, it's fine to say that it's a political issue—I don't know what that means—but the real issue is that Mexico follows a lot of domestic policies that makes it very hard for them to achieve economic growth.

And that's why your emphasis on the structural adjustment loans is so important.

Chairman LUNDINE. Well, that leads me to ask Dr. Roett—I agree with the generalizations you've been making. But the question is what to do about the capital flight in Mexico. And specifically, I want to interject one additional concept here.

We get frequent reports that there's a great deal of corruption, out and out corruption, in Mexico. The question, the intricate problem is that their revenue from oil has decreased rather dramatically. It's true, their interest rates have also decreased, but probably by not as much as their falloff in oil revenues.

We want to be helpful. We want to see the Mexican economy grow for a lot of reasons, some of them selfish. We don't want to be subjected to the problems of a terrible economic collapse there.

What can we do? Acknowledging that it's a political problem for both of us, what can we do to encourage them to take measures? What kind of measures will be successful in stemming capital flight and what can we do to encourage them to frankly face up to the level of corruption problems that there may be?

Dr. ROETT. What you need is something many people have explored quietly and in private in Washington during the last 6 to 8 months, something which is, in fact, secret.

That is, a negotiation, a diplomatic negotiation initiative between the United States Government and the Mexican Government to

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identify a set of internal structural policy reforms the Mexicans would take, not under the glare of the Miami Herald and the New York Times. Nor under the glare of this July election, which, again, probably demonstrates the fact that you just mentioned—corruption in the Mexican political system. A set of reforms that will move through this 6-year term of Mr. de la Madrid into the next 6-year period, something that we have never attempted before in the United States with any of our neighbors.

That is, a medium- to long-term set of financial supports, through the existing mechanisms, but providing medium-term guarantees that if certain kinds of internal decisions are taken with regard to the exchange rate, and private investment possibilities, new moneys will be forthcoming. We cannot expect to see changes within 1 year. We are talking here about 2 to 4 years, if not 5 years, and through a different administration in this country with the President's successor being elected in 2 years and through another government in Mexico—very difficult and very complicated.

There are people who are now thinking that that is precisely the way we must move with Mexico; that is, to do it quietly and not publicly, and not to provide large amounts of extraordinary money, but to repackage, as I said before, what is existing now in quiet negotiations with Mexico.

The only way you are going to begin to get a turn around is by having a different level of public commitment on the part of Mexican politicians. We know there are groups in the Mexican Government, as well as in the governing party, who are concerned about the direction which Mexico is taking. Those are precisely the people with which the United States wants to be identified.

It is clearly the way in which we need to go if we are going to find anything other than a short-term solution to Mexico.

It is possible that oil prices may go up at the end of this year and there will then be a leveling off of concern about the Mexican case. That is not going to stop the issues that we've discussed here from continuing.

Therefore, what we are talking about, if we turn around and ignore that situation, is a continuing hemorrhaging in Mexico which has implications in the Southwest, with very important internal domestic political implications, as well as implications for future foreign investment because investment is flat, if not negative, in Mexico in terms of the private sector.

What we are calling for here, then, is a very different approach, not just a day-by-day, normal, average approach dealing bilaterally with any country in the world, but a country in this hemisphere and, more importantly, I would argue, the country that has been pointed out by the President himself in his recent speeches as a key and crucial national security issue for this country, if, indeed, the process in Central America moves a certain way.

Certainly, with that kind of endorsement from the President himself, greater minds than mine can certainly find ways to structure a package—call it what you will, if you don't like the term "political," call it security-wise—ultimately, in the last phase, our relationship with Mexico is a national security relationship and not merely a day-to-day banking one or a day-to-day political one.

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Chairman LUNDINE. I don't mean to pick on that word, but you also said that interest rates are a political decision. But they are really a marketplace decision. Even the World Bank has to go out and borrow money in order to lend it. The rates at which it's able to borrow are more driven by the marketplace than they are by any political value judgment we might make.

Dr. ROETT. Also driven, though, by things like the deficit and by tax policy and other kinds of decisions, fiscal and monetary policies. I mean decisions taken by the government of the industrial countries, of which the United States is the leading one.

In that sense, public policy certainly has an impact on the level of interest which in turn has a tremendous effect on the Third World.

The question of interest has also become the major issue, whether that is correct or not, in the dialog between the United States and Latin America.

Chairman LUNDINE. Well, that's the final question I want to ask you. Let me make an observation and then ask you to comment on it.

It seems to me that to some degree, we and the Latin American countries are talking past one another. They're talking about interest rates being excessive and we're talking about policy changes.

And it strikes me that they're not listening much to what we're saying and we're not listening much to what they are saying.

Your comment, please.

Dr. ROETT. Yes. Very briefly, you're quite correct. I think that illuminates the growing sense of frustration apparent in the communiques of the Cartagena Consensus Group, both in late 1985 and early 1986, and in the opinion of the people who participated in those meetings.

They may well be wrong, that interest rates are not the issue, but they have not yet had that clarified sufficiently for them, nor have they had a different focus provided to give them some incentive that interest rates are part of a larger issue and not the only issue.

Chairman LUNDINE. Mr. Clark, I was somewhat surprised that you indicated that the global banking group has given a written acknowledgment to Secretary Baker that you are willing to put up the $20 billion that he has asked.

That fully includes the European and Japanese banks, as well as American?

Mr. CLARK. Yes, sir.

Chairman LUNDINE. Isn't it true that the European banks have set aside higher reserves against losses for Latin American debt than American banks have? And if so, are you concerned that—our reserves of all U.S. banks. I am not asking you about your own, exclusively—but that all U.S. banks may not have adequate reserves against that possibility?

Mr. CLARK. This is, of course, a very complex subject, Congressman Lundine, because reserves against bad loans, the process varies enormously country by country. In Europe, they have the so-called hidden reserves, for example, and the reserves that they talk about, about being very large are in the hidden reserve category. They never have disclosed numbers.

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In the United States, what we have done is we have built up—practically all U.S. banks in the last 3 years—have built up very general loan loss provisions. And we haven't allocated them. We could allocate them and we could allocate them very substantially against our country risk if we chose to do so.

But the regulators and we agree that the reserves are there and we'll see what happens before we actually use them.

So the systems are very different. It isn't clear—if we took our reserves that we have built up against the last 3 years and if we did apply them to the country risk category, and if we knew what the Europeans were doing or the Japanese were, it isn't clear who has made the greatest provisions.

There are also very substantial tax considerations involved here which aren't clear. So it's really very hard to know.

We continue to feel, as you can tell by my testimony, that when you get into country risk, working with these countries over time, we can develop programs with them so that we can once again be back and lending to them currently again. And we have several examples.

We have already lived through the Turkish Program and we are now lending to Turkey again.

So these countries do come back. They do recover. We are in the process right now—it's a small point, but it illustrates a process—Zaire, in spite of very poor copper prices, is performing very well and is recovering its position. I think it will be declassified in another year and we are making new loans.

So it's a cyclical sort of thing.

Could I make one comment about what Dr. Roett mentioned in answer to your comment about corruption in Mexico?

I agree with what he said about discussions should take place. But, Mr. Chairman, we have a vehicle for that and that is your World Bank structural adjustment loan. I think the suggestion here is that somehow, the U.S. Government should perform that role. I don't know why.

But I think, really, what you want to do in this area is right on and the only thing that I would suggest is that it's much better for the World Bank to go in and do this sort of thing—it's very hard for the Mexicans to negotiate bilaterally with the United States Government, given all of the sensitivities that are involved.

So I just think you might note that that's something that can be taken up within the context of a good Structural Adjustment Loan Program between the World Bank and Mexico.

Chairman LUNDINE. Thank you very much.

Mr. Levin?

Mr. LEVIN. Just a brief question. I missed, of course, the earlier part of the testimony.

As I read your testimony, Mr. Clark, and hear the answers to the questions, your reaction to proposed legislation is what? It's not clear to me. You seem to be a proponent of implementing what's been enunciated. Is that no further action on our part or is that a mistaken impression on my part?

Mr. CLARK. Well, I think, Congressman Levin, the most important thing is that the legislation, as it's currently proposed, would change the role of the World Bank in the sense that today, we

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don't get any kind of support for our exposure from the World Bank.

And the idea here is that maybe if the World Bank was more involved with us, we might make more loans. And that might very well be the case. But it would mean that the World Bank would assume some of our risks, which today they do zero.

By the way, Chairman Lundine, you might be interested, if you call in somebody from the World Bank today to testify, the current thinking in the World Bank is they don't want to get involved. There was a time, I think in the middle of Mr. Clausen's administration, when they were more tempted to get involved. And, for example, they guaranteed partially some loans that we made to Chile and Uruguay. I think today they wouldn't do that. The current thinking over there is that what's really important for them is their perception in the capital markets, the 1-to-1 and not supporting the commercial banks.

Today, there's a great reluctance I think on their part now—it will be interesting to see——

Chairman LUNDINE. Will the gentleman yield?

As long as you've raised that point, you don't think that the 1-to-1, asset-to-loan ratio is particularly important?

Mr. CLARK. It's very important. It's very important. I noticed that Pedro-Pablo Kuczynsk, submitted a paper on it. I would tend to agree with him that once you get away from the 1-to-1, it's hard to know how far you go.

Chairman LUNDINE. Excuse me.

Mr. LEVIN. Which means you think we ought to leave it as it is.

Mr. CLARK. I would; yes.

Chairman LUNDINE. But let me——

Mr. LEVIN. Please, go ahead.

Chairman LUNDINE [continuing]. Just pick up on that. As one witness said last week, and I can't remember who——

Mr. CLARK. Bill Cline, probably.

Chairman LUNDINE. Bill Cline, it was; yes—said, the best choice is a general capital increase. You may not even need any paid-in capital. But he did concede if, politically, you're limited in how much of a general capital increase you can get through the Congress, as a second choice he would accept a higher leveraging.

Would you agree?

Mr. CLARK. Reluctantly.

Mr. LEVIN. Which, I think, means you don't.

Chairman LUNDINE. He'd rather not.

Mr. CLARK. It's a very poor second choice, in my opinion.

Mr. LEVIN. So, essentially, you think if we're not out of the woods yet collectively on this vital matter, we're seeing the edge of the woods?

Mr. CLARK. My statement was that we are about halfway through since August 1982, Congressman.

Mr. LEVIN. And we are moving in the right direction. So, essentially, Congress should leave it alone.

Mr. CLARK. Congress should leave it alone in the sense that Congress shouldn't offer to the private sector some kind of guarantees or supports and that sort of thing. I think that's bad.

Mr. LEVIN. Or requirements.

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Mr. CLARK. I beg your pardon?

Mr. LEVIN. Or requirements as to stretchouts or to anything else.

Mr. CLARK. Well, the stretchout thing is an interesting subject. You know, that's intended to be a helpful suggestion. But I know at least in Citibank, when we have a bad loan, we write it off. And the idea that you sort of give us time to stretch it out, you have to check that with the accountants and with the analysts because if you've got a bad loan, if you're a banker, it's kind of part of our religion—if you've got a bad loan, you write it off. You face up to it.

Mr. LEVIN. Have you ever written off a loan to a foreign government or a subentity of that?

Maybe that's confidential information.

Mr. CLARK. No; it isn't. I will be glad to answer the question.

We do it from time to time. There are two things. One, government entities may go bankrupt, and in that case, that's a credit and we write those off. We've had a lot of those around the world.

The other thing is the transfer risk type thing where the dollars just aren't temporarily available. There, also, we do have writeoffs. We have a process with the Comptroller of the Currency. We have six countries around the world where we have to write off 15 percent of our exposure every year.

They are Peru, Bolivia, Sudan, Nicaragua, Zaire, and I think now Liberia we're writing off, those six countries.

Poland also. I should have mentioned Poland. We also write off our Polish exposure.

Mr. LEVIN. Fifteen percent per year.

Mr. CLARK. That's the guideline that we have from the Comptroller of the Currency; yes, sir.

That doesn't add up to a lot of money.

Mr. LEVIN. Now the largest would be Peru.

Mr. CLARK. Poland would be the largest for many banks.

Mr. LEVIN. The very largest debts you have not written off at all?

Mr. CLARK. The country risk component; that's correct. We have no reserves specifically set aside for our Mexican exposure or our Argentine exposure or our Brazilian exposure, the large ones; that's correct.

Mr. LEVIN. And if these were companies that owed you tens of billions, you would have some kind of a reserve; no?

Mr. CLARK. Congressman Levin, this is a fascinating subject, but it's a very big subject. We're talking now about the difference between a private company that may go into bankruptcy and be liquidated and cease to exist and you collect what you can out of the liquidation and, on the other hand, we're talking about Brazil and Mexico and so on that have their good years and their bad years, but there's no chapter 11, there's no liquidation. They don't disappear. The claims are there.

Probably the most dramatic example of that was Nicaragua, when we had to switch from Mr. Somoza to the Sandinistas. The Sandinistas never wanted to recognize the previous debt. But they do and they service it.

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Mrs. Aquino will have this interesting problem, by the way, in the Philippines. What's she going to do about the debt that she would classify as Marcos' debt.

Mr. LEVIN. She's going to collect a good part of it back, hopefully. [Laughter.]

Mr. CLARK. We hope so. That's the best answer. [Laughter.]

Mr. LEVIN. It's a big matter, but, in a sense, as I finish, it's kind of the heart of the matter because the basic issue is how peerless are these huge debts and how do we handle them?

And essentially, your bank and others are taking the position, one way or another, adjustments have to be made. Payments have to be made. They will be made over time.

Mr. CLARK. They are being made.

Mr. LEVIN. Everybody will get their money back and those who owed money will pay it in full.

Mr. CLARK. No, sir. If I could correct that, right up until the end, you were right on.

We aren't looking to get our money back. We are looking to arrive at a situation where the total size of the debt, country by country, is sufficiently small relative to their export level and to the GNP's and so on, that we're comfortable with that exposure.

Mr. LEVIN. Comfortable in the sense that you get your money back.

Mr. CLARK. No, no. Comfortable in the sense that we're prepared to make new loans.

Mr. LEVIN. With the ultimate purpose of receiving back what you lent. You're only loaning money additionally so that what you now owe will be paid back.

Mr. CLARK. Do we ever expect that the U.S. Government is ever going to pay back the $2 trillion of debt that's currently outstanding? Nobody expects that. We don't expect to be repaid.

It would be terrible if everybody that borrowed from us paid the loans. We'd be out of business. [Laughter.]

And we don't worry much about it because it's not going to happen. [Laughter.]

Mr. LEVIN. That is a good subject. That's an esoteric one.

Mr. CLARK. It's a big subject; yes. We anticipate——

Mr. LEVIN. I didn't say pay back so they owe nothing, but they keep on paying back as they borrow. So you loan more—I'm not castigating you, but there's been a notion that everybody can get out of this with their full skins on.

I mean, that's your basic assumption.

Mr. CLARK. That's exactly what we're going to do, Congressman. We have a lot of countries today—it's a long, long list. It's Korea, it's Taiwan, it's Singapore, it's Malaysia, it's Thailand, it's Hong Kong—if they come in and they pay us $1 million on a loan, we'll say, terrific. How about a new loan for $1 million

We don't want to be paid out of those situations. They're strong credits.

Mr. LEVIN. I understand that. You want to be paid, not paid out.

Mr. CLARK. We want to be paid, not paid out.

Mr. LEVIN. Thank you.

Mr. CLARK. Yes, sir.

Chairman LUNDINE. Mr. McCandless, briefly.

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Mr. MCCANDLESS. Thank you. Very briefly.

Representing southern California, what happens to Mexico has a far greater impact upon me than someone representing Maine. And the concern that I have about some of the things that we've talked about here, and I share Congressman Bereuter's concern that we're not really looking at this with total vision, but with somewhat tunnel vision.

The fact that I was very pleased, Dr. Roett, that you mentioned that there were private negotiations taking place between the two countries in order to, hopefully, stimulate some major changes within the internal structure. But having just enough knowledge of Mexico to be dangerous, the fact that he wins election after election, but the elections are declared null and void and the free candidate continues to rule whatever it may be, representing the legislature, whatever, is one of the very basic things, business as usual.

That deals in the corruptive aspect from the city level on up, because you've got a structure in place that feeds upward and rewards downward.

Do you have any comments on that, because without some kind of a change there, the rest of it is going to be cosmetic.

Dr. ROETT. Mr. McCandless, I think you've touched a very important point. As President Reagan has pointed out on a number of occasions, Latin America has experienced a wave of democratization unknown in its history, minus Paraguay, Chile, and, to some degree, Mexico, which is flying in the face of history.

Mexico has become less, rather than more, democratic over the passing decades. And as the chairman pointed out, the usual corruption is not merely a question of economics, but is increasingly one that has impact upon the political system itself, as you are well aware coming from southern California.

This summer's elections in Chihuahua, for example, are important elections, in which it is possible that the PAN, the major opposition party, will once again win, but will not be given the right to take that statehouse.

As I stated we are dealing with a situation unlike that of Argentina, where democratic institutions are stronger now than they were 3 years ago, or in Brazil, where they're stronger than they were 3 or 4 years ago, or in other countries, like Ecuador, where they are really much stronger than they have been for a long time, Guatemala, et cetera. In Mexico, they are not.

And while we may be talking about trade, and that's a very important part of the bill that we haven't touched on very much, or about the role of the private commercial banks, in the end, it is, of course, the politics that drives the economics and the finances in all of these countries.

Let's be very realistic about that.

Therefore, I think what you are saying represents the standing wisdom on the Mexican political system by experts on both sides of the border, that the situation in Mexico is becoming increasingly polarized, that there are very serious social and economic problems, and that is the realistic context within which private commercial banks, multinational corporations, and all other institutions, have got to focus.

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So that, you knowing Mexico, my knowing something about Mexico, means that, ultimately, the outcome will be decided at the political level, not at any other level. It's not going to be decided at the World Bank or any IDB. It's going to be decided by the Mexicans, themselves.

But I would hope that the overtures that the United States makes are very clear about the mutual damage that will come out of this process if it is not in some way stopped or turned around or redefined for the good of both our countries.

That really has been the thrust of my comments here this morning, that what has happened is unfortunate. You can't blame any particular institution in this country, obviously, nor should we be in the position of bailing out Mexico, just as we shouldn't be accused of bailing out the banks in the debt crisis. Nevertheless, we have moved to a new stage of sensitivity, I hope, in the public and private sector with regard to Mexico. And while I hope Mr. Clark is right and Mexico turns itself around, like Turkey does, I don't think that the existing knowledge or opinion about that system would indicate that is likely in the foreseeable future, even if oil prices were to go back up to $20 or $22 a barrel. Not impossible.

The issues we are talking about here, unfortunately, would probably continue and might even worsen. That's the problem, that the income from increased oil probably would not be invested and directed in the kinds of corrective measures that we would like to see happen in Mexico to restore that country to being creditworthy, to give it a strong private sector, and to resolve some of those social problems.

Mr. McCANDLESS. Mr. Clark, I would like to share your optimism. Currently, Mexico, if I understand demographics correctly, is paying about half of its interest on principal.

Is that a correct number?

Mr. CLARK. I'm sorry, Congressman?

Mr. McCANDLESS. Paying half of the interest that it owes on principal.

Mr. CLARK. Half of the interest.

Mr. McCANDLESS. It is not current on its interest debts.

Mr. CLARK. Oh, it's current, sir. Yes, sir. Yes; it pays about $10 billion a year on interest on its foreign debt and it is current.

It has the use of $100 billion.

Mr. McCANDLESS. No; I am talking about, it's current on all of its interest.

Mr. CLARK. Yes; it's current.

Mr. McCANDLESS. Public and private.

Mr. CLARK. Yes, sir.

Mr. McCANDLESS. OK; I understand what you said when you say, as long as the ability to pay is there, you're not so much interested in the principal.

Mr. CLARK. Right.

Mr. McCANDLESS. And you are certainly willing to negotiate further loans, given the ability to pay.

Mr. CLARK. That's the idea.

Mr. McCANDLESS. Having been in business and having never been out of debt—[Laughter]—I understand.

Mr. CLARK. You're a good client of the banks.

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Mr. McCANDLESS. Yes; for many years. Where do you arrive at a conclusion such as Mexico? It would appear to me that they're not in a position to have the ability to pay in the sense of additional loans.

But if I gathered right, additional loans are not necessarily something you're not looking at.

Mr. CLARK. There's a wonderful statement in your—I'm sorry.

Mr. McCANDLESS. Let me throw this out. It seems to me, like with Mexico, further loans would bury them further. Now I understand, maybe not, but that's what I kind of——

Mr. CLARK. There's a wonderful statement in the material that you've worked up that says that if Latins would repatriate home the moneys they have abroad, there wouldn't be any debt.

Mr. McCANDLESS. No question.

Mr. CLARK. So, I think when you say that, then everybody thinks, ah, well, yes; that is right. Mexico isn't as desperate as we thought it was. There's all of this money out of the country. What can the Mexicans do to get some of that back?

And we are talking about a deficit with the Mexicans of—the numbers vary—$3, $4, $5 billion. But if they can follow policies that will bring back 10 percent of the moneys that the Mexicans themselves hold abroad, you haven't got a balance-of-payments problem. And what has been perceived to be a hopeless case becomes a very easy case.

So, once again, the emphasis has to be on what the Mexicans can do to attract back their own capital.

In 1982, when Mr. de la Madrid first came into office, they had a very substantial economic program. It was a big success and the capital flows were inward to Mexico. And they can do that again.

You have to do a couple of things. You have to have an exchange rate that makes it so when you sell dollars, you get a lot of pesos for them and you have to have good domestic interest rates so that people are happy to save—and that's part of what the IMF and the structural adjustment loans from the World Bank are currently discussing with Mexico.

And if they're successful, what's perceived to be a crisis is going to turn out to be a very manageable problem.

Mr. McCANDLESS. Thank you both. It's been very interesting this morning.

Thank you.

Chairman LUNDINE. It really has. I want to thank you very much, both of you, for your insight, your knowledge, and also for your candor.

Congressional hearings aren't always the best forum calculated to bring out people's candid evaluations. But I think today was extraordinary in that respect and your testimony has been very valuable to us as we prepare to try to grasp something that will advance the cause of the debtor countries being able to grow and prosper and the United States being able to not only sustain its financial position, but, as Mr. Roett just mentioned, also engage in some trade with these countries.

Speaking of trade, tomorrow's hearing will be exclusively dedicated to the subject of trade. Paula Stern, Chair of the International Trade Commission, Alan Wolff, former trade representative,

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Stuart Tucker of the Overseas Development Council, and J.B.L. Pierce, treasurer of Boeing Co., will be the witnesses.

This hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was recessed, to reconvene at 10:30 a.m., on Wednesday, March 19, 1986.]

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THIRD WORLD DEBT LEGISLATION

WEDNESDAY, MARCH 19, 1986

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:36 a.m., in room 2128 of the Rayburn House Office Building, Hon. Stan Lundine (chairman of the subcommittee) presiding.

Present: Chairman Lundine, Representatives Bereuter and McCandless.

Chairman LUNDINE. The Subcommittee on International Development Institutions and Finance will come to order.

I am, without objection, going to put my entire opening statement in the record and summarize it and then encourage the witnesses to do likewise.

[The opening statement of Chairman Lundine follows:]

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OPENING STATEMENT OF STAN LUNDINE, CHAIRMAN,
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT INSTITUTIONS AND FINANCE
MARCH 19, 1986

The U.S. trade deficit has nearly quadrupled since the onset of the developing country debt crisis in 1982. In 1985, the U.S. trade deficit was an unprecedented $148.5 Billion. It is no accident that our trade deficit is rising during this period of excessive developing country indebtedness.

Ten out of twenty of the largest U.S. trading partners are developing countries. Four of the ten are also the world's largest developing country debtors. Since the onset of the debt crisis, the U.S. has been losing valuable markets in these debt-ridden countries. To service their foreign debts, debtor countries have had to cuts imports and boost exports. Seventy percent of the world wide decline in U.S. overseas sales since 1980 can be attributed to falling demand in Latin America. By 1974, the U.S. trade deficit with Latin America was larger than the U.S. trade deficit with Western Europe, OPEC, or Canada.

In the meantime, U.S. imports from developing countries have been growing. Since 1982, U.S. imports from the ten major debtors have increased by twenty-eight percent. U.S. markets have remained relatively open to our developing country friends. However, the same cannot be said for some of our other industrialized trading partners. European imports of developing country goods have only increased by five percent since the debt crisis hit, and developing country exports to the Japanese actually fell by twenty percent!

This unequal distribution -- between U.S. imports and exports to developing countries -- and between the U.S. and other industrialized trading partners -- cannot continue indefinitely. U.S. manufacturing firms and U.S. farmers are suffering from the failure to address the debt-trade connection with foresight and initiative.

We must move forward with policies which can address debt to facilitate trade. As we move forward on the debt side, developing countries must be required to open their markets to more imports. They also must understand that maintaining trade barriers in higher value added products of particular interest to the United States is unacceptable to us.

The draft legislation we have before us will address debt, but also require gradual trade liberalization by developing countries. Whether the United States is participating in efforts through the multilateral development institutions or negotiating trade agreements directly with developing countries, our policy of more assistance on debt in exchange for trade liberalization must be clear.

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The House leadership has indicated that it intends to move a comprehensive trade bill to the House floor in early May. The draft legislation we are considering here today will be a part of that legislative package. We have an opportunity to make a real contribution to furthering the dialogue regarding what to do about the debt crisis and how to facilitate exports to our most lucrative future markets.

Ultimately, what is at stake for all of us is jobs and the preservation of a high standard of living for Americans. Jobs gained through expanding trade, not contracting it.

We are fortunate today to have with us some superb witnesses on the debt-trade link. Paula Stern, Chairwoman of the International Trade Commission, will tell us of some of the trade effects the I.T.C. has seen from developing country debt in cases they have had before them, and about a recent initiative at the I.T.C. to look deeper into the debt-trade link. Few people in Washington surpass the thorough understanding I believe Alan Wolff, Deputy Trade Negotiator under the Carter Administration, has for the whole gamit of trade issues facing our country. Stuart Tucker with the Overseas Development Council has recently completed an important study of the effects on U.S. jobs and markets from developing country debt. Finally, J.B.L. Pierce of Boeing, will give us important insight regarding what a private firm has been up against as they have tried to penetrate developing country markets in the debt crisis environment.

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Chairman LUNDINE. The U.S. trade deficit has nearly quadrupled since the onset of the developing country debt crisis in 1982. As is familiar to most of us, the trade deficit reached $148.5 billion last year. Ten out of the twenty largest U.S. trading partners are developing countries. Four out of those ten have serious debt problems.

Since the onset of the debt crisis, the United States has been losing valuable markets in these developing and debt-ridden countries.

To service their foreign debts, they've had to choke off imports and boost their exports. Seventy percent of the world-wide decline in U.S. overseas sales since 1980 can be attributed to falling demand in Latin America alone.

In the meantime, our imports from the developing countries have been growing. Since 1982, U.S. imports from the 10 major debtors have increased by 28 percent. U.S. markets have remained fairly open, relatively open to our developing country friends.

On the other hand, European imports of developing country goods have only increased by 5 percent and developing countries to the Japanese actually fell by 20 percent during this period of time.

It seems as though we are doing more than our fair share to take the products of these debt-ridden developing countries at least in comparison with our major trading partners. We must move forward to address the problems of these developing countries. At the same time, we should strike a bargain, I believe, that their markets be relatively open to imports, particularly of high value-added products from the United States.

We have very much draft legislation. We have shared that with the witnesses here today and really welcome their constructive comments.

The reason I have not introduced a bill on the floor of the House at this time is that I encourage change and constructive criticism at this point in time.

The House leadership has indicated that we are going to do a comprehensive trade bill during the month of May. It will have several titles and we hope that we will able to craft a title on the debt-ridden countries and the effect of trade relations with debt-ridden, developing countries as one aspect of that comprehensive trade legislation.

We are fortunate today to have with us some superb witnesses on the debt-trade link.

Paula Stern, chairwoman of the International Trade Commission, will tell us some of the trade effects the ITC has seen from developing country debt. I don't know if she's prepared to testify to this point, but having talked with her recently, I also know that she is fairly recently back from Brazil and has some observations about one of the major debt-ridden developing countries.

Alan Wolff, a longtime friend and respected deputy trade negotiator during the Carter administration, has valuable expertise in a gamut of trade issues facing our country.

Stuart Tucker of the Overseas Development Council has recently completed an important study of the effects on U.S. jobs and markets from developing country debt.

And finally, J.B.L. Pierce of Boeing will give us important insight regarding what a private firm is up against as they have

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tried to penetrate developing country markets in a debt crisis environment.

All of your statements will be made a part of the record in their entirety, and I would urge you to summarize to the extent possible. Before that, would you like to make any opening remarks, Mr. Bereuter?

Mr. BEREUTER. Nothing, Mr. Chairman. Thank you.

Chairman LUNDINE. OK. Then I think what we will do is take this panel in the entirety before we open it up to questions. And I believe we will start with you, Ms. Stern.

STATEMENT OF DR. PAULA STERN, CHAIRWOMAN, INTERNATIONAL TRADE COMMISSION

Dr. STERN. Good morning, Mr. Chairman, members of the committee.

I appreciate being invited to discuss with you this morning the topic. I would like to emphasize, however, that I am offering my own personal observations based on experience at the U.S. International Trade Commission, but those observations should not be construed as representing the position of the ITC.

The purpose of my testimony will be to highlight some of the consequences for the United States, past and present, attributable to the ongoing liquidity crunch afflicting Latin America and so many other developing countries.

The first part of my testimony which you have covers the origins of the sovereign debt problem and its impact on developing countries. And since this committee is so well informed on that topic, I would like to go directly to summarizing the consequences of the debt problem on the United States.

In the wake of austerity measures imposed on most of the heavily indebted countries, the United States incurred growing trade deficits with its developing country trading partners. U.S. exports to 7 of the largest debtor countries declined from $34 billion in 1981 to $18 billion in 1983, accounting for nearly one-half of the total decline in U.S. exports during that period.

Now a variety of estimates, differing in their approaches, have put the total effect on domestic employment due to recession in the debtor countries anywhere from 200,000 jobs to over a million.

A second consequence of the recession among heavily-indebted countries has been the decline in earnings on U.S. investments based in debtor countries. Again, from 1981–83, income from direct investment in Latin America dropped from $6 billion to under $1 billion.

A third implication of the recession in debtor countries lies in its indirect impact on the dollar's value. Changing profit prospects in debtor countries resulted in shifting investment commitments, contributing to the dollar's appreciation by shifting the flow of dollars supplied or demanded on the foreign exchange market.

Other consequences can be found in the increased vulnerability of the world's financial system and even in increased immigration to the United States.

Perhaps least well appreciated among the consequences from the sovereign debt problem have been the constraints imposed upon

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U.S. economic policymakers. In particular, the Federal Reserve has been compelled to keep a watchful eye on possible repercussions that policy shifts may have for debtor country burdens.

Over the last 12 months, and particularly since September, the dollar has declined markedly against most of the major industrialized countries' currencies.

Now will this appreciation of the dollar restore balance to U.S. trade with the developing countries? The recent decline in the dollar's value can be expected to result in some increase in exports of U.S. made products to debtor countries. With the dollar's decline, U.S. products are now less costly relative to goods from Europe or Japan, for example. Debtor countries can be expected to switch toward U.S. goods at the expense of other imports.

However, the dollar's recent decline did not extend to most of the developing country currencies and consequently, a narrowing of the U.S. deficit in trade with these nations because of recent exchange rate movements should not be expected.

Turning to more specific effects on U.S. industries, exports to debtor countries declined for a broad range of industries in the United States. Some sectors were much more adversely affected than others. Exports of motor vehicles, aircraft, power-generating equipment, machinery, and basic iron and steel products fell by more than 50 percent between that period, 1981–83. And exports to debtor countries continue to be 20 percent below levels reached in 1980.

The liquidity crunch also affected agricultural exports, since Mexico and Brazil have been major consumers of U.S. farm products. Again from 1981 to 1983, Mexico's imports of U.S. agricultural products fell by over 50 percent, for a net decline of $1.3 billion.

Brazilian imports over the same period declined by a third, falling by over $200 million. Overall, agricultural exports to Latin America declined by about 30 percent.

Although these exports have since recovered, they are still below the peak levels experienced in 1980. I might add that the ITC is presently contemplating a study into the effects of the debt problem on overall U.S. trade and employment.

Now I would like to direct your attention to certain implications of the debt problem for U.S. trade policy. The timing of unfair trade petitions at the ITC clearly suggests that sovereign debt has contributed to the rising caseload at the ITC.

Since 1980, we have conducted over 650 antidumping and countervailing duty cases, with more than one quarter representing complaints against debtor countries. Of the nearly 100 cases brought against Argentina, Brazil, Mexico, and Venezuela alone since January 1980, all but 10 have been filed since the start of 1982.

As a result, there has arisen a basic conflict in the conduct of U.S. trade policy, dividing the interests of domestic industries from those of debtor nations.

Let me give several examples of situations in which this conflict has arisen.

Mexico. Now Mexico has reacted to its debt difficulties by vigorously promoting non-oil exports supported by a wide range of subsi-

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dies. Competing U.S. industries responded by bringing countervailing duty petitions against Mexico in unprecedented numbers.

Since Mexico has not been a signatory to the GATT subsidies code, it's not been entitled to a material injury test at the ITC. As a result, countervailing duty orders have been put into force on a variety of Mexican exports, including steel, cement, ceramic tiles, bricks, textiles, lime, and fresh flowers.

Recently, however, an accord was reached that will entitle allegedly subsidized Mexican imports to the injury test at the ITC and in exchange, the accord commits Mexico to phasing out of a variety of export subsidies.

Turning now to Brazil. Brazil has been the target of more unfair trade petitions than any other trading partner in recent years, with 48 cases filed again since 1980. Citing this proliferation of formal protest against Brazilian exports, concern over United States trade complaints have been a prominent feature in public policy discussions in Brazil.

The United States continues to be Brazil's largest export customer, accounting for 28 percent of Brazil's total exports and 40 percent of its total trade surplus. Most of the complaints filed by U.S. industries were under the unfair trade provisions of our law. Countervailing duty orders have been applied to orange juice concentrates, castor oil products, and certain agricultural tools.

Many of the other petitions against Brazilian exports have culminated in a bilateral restraint agreement on steel as part of a comprehensive plan by the President to limit total United States steel imports from major foreign suppliers.

Perhaps the greatest concern confronting United States industry comes from Brazilian mercantilist trade practices, emphasizing import substitution. The ITC recently investigated the industrial targeting policies of its major trading partners, including Brazil, and in this study, which we published, but isn't made public, it was revealed that the Brazilian Government intervenes extensively on behalf of its favored industries. And we go into some detail on some of those industries.

Now this basic conflict have been talking about between trade policy and debt considerations has been particularly well illustrated by the U.S. copper mining industries' recent petition for relief under section 201, our escape clause. The copper case presented many difficulties for the Commission.

Once we unanimously agreed that the industry met the statute's injury criteria, we then had to devise a remedy. The law gives us a choice of three alternative remedies—trade adjustment assistance, tariffs, or quotas.

However, as you know, future funding of trade adjustment assistance has been quite uncertain and also, both tariffs and quotas in this particular case of copper threatened to create a two-tiered price system in which U.S. copper prices would have been higher than the world price, and this would have hurt the copper fabricators and ultimately, the U.S. copper producers.

A close examination of the facts regarding the copper industry's problems in the United States would reveal it to be among the world's highest cost producers. The global market for copper has dictated a world price beneath the U.S. production costs.

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But the ITC could not, by law, make a recommendation to reduce global production that the domestic industry contended it needed for it to remain in business and thus, the Commission offered a split recommendation with two commissioners favoring tariffs and two favoring quotas.

In any event, debtor country problems were not a factor in the Commission's analysis. Such considerations apparently, however, were important to the President. Then Trade Representative Bill Brock stated that high-debt copper exporters such as Chile and Peru urgently needed the earnings from increased copper exports to service their debts.

Chile, as you may know, depends upon copper for 60 percent of its exports, while Peru depends on as much as 32 percent.

So the United States would have further compounded the debt burdens of those two countries by limiting access to vital U.S. markets in the one commodity these two economies depend upon most heavily for their export revenues.

To conclude, current attempts to solve the debt problem have led to policies in debtor countries that shut out U.S. exports and encourage increases in imports into the U.S. markets. Existing remedies for exporters and industries like copper that compete in world markets distorted by the debt problem should be strengthened.

The import relief system administered by the ITC provides an avenue for injured U.S. industries to seek relief. But relief under this system poses, if you will, a zero-sum situation, with gains to domestic industries coming at the expense again of debtor nations' exports.

All of this points to the need for a more comprehensive solution to the sovereign debt problem. I am not an expert on international financial matters and I will defer to those who are in devising specific proposals in that arena.

My purpose today, however, is to reinforce the need for a solution that does not embody the conflict between United States and debtor interests.

One comment I will make, however, is that, to the extent that it's feasible, the new policy should encourage internal economic reforms in the debtor countries. While the austerity programs have led to significant government intervention in foreign trade in those nations, many of those countries had already a long history of policies to encourage import substitution. Programs to assist these countries in the future to meet their debt servicing needs may offer a unique opportunity to achieve a less restrictive environment for trade to the benefit of all—LDC's and the United States alike.

I would be very happy to answer any questions I may have provoked when the time comes.

[The prepared statement of Dr. Stern follows:]

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DR. PAULA STERN, CHAIRWOMAN

U.S. INTERNATIONAL TRADE COMMISSION

STATEMENT FOR THE SUBCOMMITTEE

ON INTERNATIONAL INSTITUTIONS AND FINANCE,

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

MARCH 19, 1986

THE SOVEREIGN DEBT PROBLEM

AND

ITS IMPACT ON U.S. FOREIGN TRADE

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The Sovereign Debt Problem and U.S. Foreign Trade
Dr. Paula Stern, U.S. International Trade Commission

I would like to extend my appreciation to you, Mr. Chairman, and to all the members of the subcommittee, for this opportunity to testify this morning. My observations today are based on experience at the U.S. International Trade Commission, but my remarks should not to be construed as representing the position of the ITC.

The purpose of this testimony will be to highlight some of the consequences for the United States, past and present, attributable to the ongoing liquidity crunch afflicting Latin America and so many other developing countries. There have been direct effects on trade and jobs, foreign investment, illegal immigration, and the health of our banking institutions. Indirect effects have been felt through upward pressures on the dollar's value, and on the conduct of domestic monetary policy. The debt problem has also fostered conflicts in our international economic policymaking process. Prescriptions for containing the debt problem often appear to clash with our obligations to safeguard the economic interests of import-sensitive industries.

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Origins of the Sovereign Debt Problem

The debt crisis currently plaguing many developing countries traces its origins to the early 1970's when OPEC was able to quadruple world petroleum prices. These oil exporters soon began generating balance of payment surpluses far beyond their economies' capacity to absorb them through merchandise imports. Surplus earnings were funneled into the world's financial centers. Meanwhile, oil importing countries sought relief from mounting balance of payments deficits to pay soaring oil import bills. The world's major banks, flush with petrodollars, aggressively 'recycled' OPEC deposits into loans for the oil importers. Multilateral lending institutions expanded sponsorship of large-scale development projects ideally suited to the commercial banks lending conditions. Many resource-abundant nations used expectations of rising prices on their primary commodity exports as collateral to finance glamorous industrial projects which were sometimes conceived with little regard for world market conditions.

The second round of oil price increases of 1979 exposed the vulnerability of the indebted countries. Since 1970, developing countries accumulated medium and long-term debt at an average annual rate of over 18 percent. Meanwhile, their GNP increased by only about 6 percent per annum. As a result, the ratio of external debt to GNP rose from 14 percent to 21 percent over the period.

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In October of 1979 the Federal Reserve adopted a new strategy for subduing inflation through restrained monetary growth. Eventually inflation declined substantially, but not before nominal and real interest rates rose to unprecedented levels. The ensuing global recession resulted in slackened demand and lower prices for the raw materials many indebted developing countries depended upon for their foreign exchange earnings. As a result, rising interest obligations clashed with declining earnings, precipitating the crisis first brought to world attention during August 1982 in Mexico City.

Since 1982, a parade of developing nations has formed in line behind Mexico, each protesting an inability to service its debt obligations. Until now, these problems have been resolved by reschedulings on a case-by-case basis. However, the sentiment is widespread that only some time has been bought. The financial and political health of most of these indebted countries hinges precariously on sustained world economic growth. An early optimism derived from dramatic progress made by Mexico, Brazil, and Argentina has yielded to a new awareness that conditions favoring sustained recovery were not laid. Austerity measures adopted by debtors focussed on short-term improvements in external trade, without concommitant internal reforms vital for a return to growth. Ironically, it is with the recent decline of crude petroleum prices that some of the most beleaguered nations now contemplate intensified adversity. Mexico, Ecuador, Nigeria, Venezuela, and Indonesia all rely heavily on oil exports. Mexico appears to be particularly hard pressed, with an interest obligation of $10 billion to meet during 1986 while its oil revenues are projected to decline by $3 to 5 billion.

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Costs of Indebtedness to the Developing Countries

As a result of their difficulties with indebtedness, and the reluctance of commercial banks to engage in all but rescheduling and interest servicing, most debtors have had to resort to the IMF for short-term financial assistance. Under the IMF principles of conditionality, client governments have been required to adopt onerous domestic austerity programs. These programs have stressed cutting imports and boosting exports, to engender the trade surpluses to meet interest obligations. With so much of the LDC debt denominated in appreciating dollars, debtors faced compounded difficulties generating dollars to make interest payments. (This was offset to some degree for countries that exported commodities priced in dollars, such as oil.) For example, with deutsch marks one-third cheaper against the dollar, Brazil had to sell correspondingly more to Germany to earn each repayment dollar.

For most of the heavily indebted developing countries, the strictures of domestic austerity resulted in what Fred Bergsten has termed the lost decade of growth. Over the period 1980–1983 average economic growth in Latin America was negative, with the region's GDP falling by over 4 percent. In spite of sustaining these pains, it has become clear that prospects for debtor countries outgrowing the debt problem have not improved. Restricted imports have served to curtail capital investment and to diminish debtor countries' capacity to produce income. With rescheduled interest payments coming due, new pressures for austerity are ahead. And still there looms concern about political stability in debtor countries if further economic sacrifices are made. Of course the political implications differ from country to country, depending also on the kind of sacrifices and the segments of society affected.

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There is ample evidence that capital flight has also been a problem for many debtor countries, thwarting efforts to restore growth in debtor countries. Negative real interest rates, overvalued currencies, and inflationary macroeconomic policies are typically held responsible. Morgan Guaranty has estimated that for ten Latin American debtors 70 percent of all net new borrowing over 1983-85 has been lost through capital flight. Mexico has been the most adversely affected, losing $16 billion while new borrowing yielded only $9 billion.

General Consequences for the United States

The recession in deeply indebted countries has affected the U.S. economy in a variety of ways. U.S. merchandise exports to these countries declined while imports have risen; foreign direct investment and their derivative earnings declined; upward pressures on the dollar were reinforced; global banking institutions weakened; domestic economic policy options narrowed; and illegal immigration accelerated.

The importance of trade to the U.S. economy has grown enormously over the last two decades. In particular, trade with developing countries grew to constitute 40 percent of total U.S. exports in 1980 and 45 percent of all exports of manufactures. In addition, one quarter of all U.S. foreign direct investment is based in developing countries. For U.S. banking institutions, over 50 percent of their overseas lending position is to developing countries, largely to Latin America.

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In the wake of austerity measures imposed on most of the heavily indebted countries, the U.S. incurred growing trade deficits with its developing country trading partners. U.S. exports to seven of the largest debtor countries (Brazil, Mexico, Argentina, Venezuela, the Philippines, Chile, and Nigeria) declined from $34 billion in 1981 to $18 billion in 1983, accounting for nearly one-half of the total decline in U.S. exports during this period. In addition, U.S. firms lost market share in third country markets in part because of efforts by debtors to increase exports worldwide. However, some of the decline in U.S. exports to debtor countries must be blamed on the dollar's appreciation vis-a-vis other industrialized countries. To the extent that debtor countries continued to import, products from Europe or the Far East were more favorably priced because of the dollar's higher value. A variety of estimates, differing in their approaches, have put the total effect on domestic employment due to recession in the debtor countries anywhere from 200,000 jobs lost to over 1 million.

A second consequence of the recession among heavily-indebted countries has been the decline in earnings on U.S. investments based in debtor countries. From 1981 to 1983, income from direct investment in Latin America dropped from $6 billion to under $1 billion, largely because rates of return plunged from about 16 percent to under 3 percent. As a result the U.S. suffered from declines on both its merchandise trade and in its services trade with debtor countries. The latter includes repatriated income from foreign direct investment, which in the past has been an important source of income offsetting U.S. merchandise trade deficits. Declines in both accounts have contributed to record U.S. external borrowing.

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A third implication of the recession in debtor countries lies in its indirect impact on the dollar's value. Changing profit prospects in debtor countries resulted in shifting investment commitments. Net direct investment by U.S. multinational firms ceased, and commercial bank lending flows were redirected when awareness of debt problem's magnitude became known in 1982. Each contributed to the dollar appreciation by shifting the flow of dollars supplied or demanded on the foreign exchange market.

The prospect for lower earnings for U.S. parents from their affiliates in debtor countries led to a cessation of new investment, and some disinvestment. U.S. foreign direct investment in Latin America fell from $39 billion in 1981 to $30 billion by 1983. This decline contrasts with rapid growth in U.S. direct foreign investment in the region over the previous decade. The reversal in overseas direct investment flows resulted in net upward pressure on the dollar.

Before 1982, when commercial banks were still lending to sovereign debtors in amounts exceeding repayment requirements, there was a net supply of dollars being made available to borrowing countries, exerting downward pressure on the dollar's foreign exchange value. As banks came to realize the prospects for default, new lending came to a halt. Debtor countries were instructed by the IMF to run large trade surpluses in order to make repayments. To the extent that repayments exceeded disbursements, a net demand for dollars was created. Concurrently, corporate tax reform in the United States promised higher after-tax profits at lower perceived risk, and increased loan demand by consumers and the Federal government provided further incentive for bankers to shift their loan portfolios away from foreign debtors. The withdrawl of U.S. banks from a net lending position vis-a-vis debtors to one of financing domestic borrowing caused a reversal in net dollar capital flows that contributed to the dollar's appreciation.

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A fourth consequence of the debt problem lies in the increased vulnerability of the world's financial system. Since 1982 banks have reduced their vulnerability to sovereign debt defaults by setting aside bad loan reserves. However, for the largest banks, exposures to major debtors remain in excess of their net worth. The consequences of a default by either a large debtor or several of the smaller debtors would require prompt and substantial infusion of liquidity by the Federal Reserve and other central banks to avert a loss of public confidence. Even with the most skillful crisis management, a resurgence of world inflation and higher interest rates could follow. Other scenarios are simply unthinkable.

Yet another outgrowth of the debt problem is the swelling tide of illegal immigration across the U.S.-Mexican frontier. Already high unemployment throughout Latin America has risen further because of the debt-induced recession, accelerating the migration. With unemployment escalating rapidly in Texas, California, Louisiana, and throughout the Southwest because of declining activity in the domestic petroleum industry, renewed attention is being given this matter.

Perhaps least well appreciated among the consequences from the sovereign debt problem have been the constraints imposed upon U.S. economic policy makers. In particular, the Federal Reserve has been compelled to keep a watchful eye on possible repercussions that policy shifts may have for debtor country burdens. To service their debts these countries have needed an economic climate of steady growth in world aggregate demand with stable or

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declining interest rates. Consequently, there has been concern over the rapid descent of the dollar. Carried too far the dollar's decline would lead skittish foreign investors to cease financing the U.S. trade deficits, thus requiring domestic interest rates to move upward as an incentive for investors to remain. Until recently these considerations limited the extent to which the Fed could opt for monetary ease, since unilateral interest rate declines would make dollar assets less attractive. Only with the sharp drop in oil prices came full agreement among the Group of Five countries to cooperate in a plan lowering world interest rates in confidence that a new round of inflation would not ensue. Only by such unprecedented coordination of monetary policies were U.S. interest rates able to be lowered without fear of setting off flight from the dollar that could ultimately affect debtor countries adversely.

Over the last twelve months, and particularly since September, the dollar has declined markedly against most of the major industrialized countries' currencies. Will this depreciation of the dollar restore balance to U.S. trade with the developing countries? The recent decline in the dollar's value can be expected to result in some increase in exports of U.S.-made products to debtor countries. With the dollar's decline, U.S. products are now less costly relative to goods from Europe or Japan. Debtor countries can be expected to switch toward U.S. goods at the expense of other imports. However, the dollar's recent decline did not extend to most of the developing country currencies. For example, the exchange rate with the Brazilian cruzeiro has been roughly unchanged in real terms since 1983. And against the Mexican peso the dollar has appreciated substantially during 1985. Consequently, a narrowing of the U.S. deficit in trade with these nations because of recent exchange rate movements is not expected.

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Turning to more specific effects on U.S. industry, exports to debtor countries declined for a broad range of industries. Some sectors were much more adversely affected than others. Exports of motor vehicles, aircraft, power-generating equipment, machinery, and basic iron and steel products fell by more than 50 percent between 1981-83. Exports to debtor countries continue to be 20 percent below levels reached in 1980.

The liquidity crunch also affected agricultural exports, since Mexico and Brazil have been major consumers of U.S. farm products. From 1981 to 1983, Mexico's imports of U.S. agricultural products fell by over 50 percent, for a net decline of $1.3 billion. Brazilian imports, totalling $640 million in 1981, declined by one-third over the same period, falling to $430 million. Overall, agricultural exports to Latin America declined by about 30 percent. Although these exports have since recovered, they are still below peak levels of 1980.

The ITC is presently contemplating a study into the effects of the debt problem on overall U.S. trade and employment, including an examination of the effects on specific industries. The study would investigate the employment effects due to changes in exports and imports, including an account of third country market effects. In the calculation of employment effects, input-output methods would be used to derive estimates of both direct and indirect employment effects. The importance of exchange rate movements would also be studied.

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Implications for the U.S. Trade Policy

Now I would like to direct your attention to certain implications from the debt problem on U.S. trade policy.

The ITC was among the first to be alerted to growing domestic concerns over rising imports. It is to the ITC that domestic firms petition for relief from foreign imports under U.S. trade statutes. The ITC caseload reveals a growing profile for debtor countries as a source of trade complaints. While much of our trade, and consequently our trade frictions, continues to be with Canada, Europe, and Japan, the caseload appears to be following the shift in trade towards developing countries. The timing of Title VII petitions clearly suggests that sovereign debt has contributed to the rising caseload. Since 1980 the ITC has conducted over 650 antidumping and countervailing duty cases, with more than one-quarter representing complaints against debtor countries. Of the nearly 100 cases brought against Argentina, Brazil, Mexico, and Venezuela alone since January 1980, all but 10 have been filed since the start of 1982.

These complaints against debtor countries were filed under U.S. trade laws legislated to protect domestic industries from unfair practices. The sovereign debt problem, on the other hand, has become a matter of concern for macroeconomic policymakers, and in fact, transcends national interests. As a result, there has arisen a basic conflict in the conduct of U.S. trade policy, dividing microeconomic interests from those with national or global perspectives. Let me give several examples of situations in which this conflict has arisen.

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Mexico.—Mexico has reacted to its debt difficulties by vigorously promoting nonoil exports supported by a wide range of subsidies. Competing U.S. industries responded by bringing countervailing duty petitions against Mexico in unprecedented numbers. Since Mexico is not a signatory to the GATT subsidies code, it is not entitled to a material injury test conducted by the ITC. As a result, countervailing duty orders have been put into force on a variety of Mexican exports, including steel, cement, ceramic tiles, bricks, textiles, lime and fresh flowers. Recently, however an accord was reached that will entitle allegedly subsidized Mexcian imports to the injury test. In exchange, the accord commits Mexico to phasing out a variety of export subsidies.

Mexico has also revised rules first announced in 1984 that would have significantly reduced domination of the pharmaceutical market by foreign-based firms through the erosion of trademark and patent protections. Also during 1985 Mexico granted easier access to imported materials as part of its promotion of nonoil exports. These new regulations allow 30 percent of a firm's export earnings to be applied to imported producer inputs without requiring import permits, and provides for duty-free status on such imports. This policy followed the Mexican government's elimination of import licencing requirements on over 500 items as part of its new export orientation.

In a significant move made in August 1985, Mexico replaced its two-tiered exchange control system in favor of a managed float. Officials hoped that a more "realistic" value of the peso would succeed in dampening import demand, spurring tourism and exports, and reducing capital flight.

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Brazil.—Citing the proliferation of formal protests against Brazilian exports in recent years, concern over U.S. trade complaints has been a prominent feature in public policy discussions in Brazil. The U.S. continues to be Brazil's largest export customer, accounting for 28 percent of Brazil's total exports, and 40 percent of its total trade surplus. Most of the complaints filed by U.S. industries were under the unfair trade provisions of U.S. law. Countervailing duty orders have been applied to orange juice concentrates, castor oil products, and certain agricultural tools. Most of the other petitions against Brazilian exports have culminated in a bilateral restraint agreement on steel as part of a comprehensive plan to limit total U.S. steel imports from major foreign suppliers.

In an escape clause action, the ITC came to a majority opinion that global quantitative restrictions be placed on imported non-rubber footwear, including imports from Brazil. President Reagen decided in August not to provide the footwear industry with import relief. Brazil's footwear industry would have been severely affected by any such limitation, as 89 percent of its leather footwear exports are currently sold in the U.S.

Brazil has been facing charges of protectionism of its own from both the IMF and the U.S. Both have been critical of Brazil's extensive use of subsidies to promote exports. Brazil has reportedly responded by phasing out many of these subsidies. Recently, Brazil is the subject of an ongoing Section 301 investigation on its legislation reserving the market for small computers to domestic producers.

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Perhaps the greatest problem confronting U.S. industry comes from Brazilian mercantilist trade practices emphasizing import substitution. The ITC recently investigated the industrial targeting policies of its major trading partners, including Brazil.[1] The study revealed that the Brazilian government intervenes extensively on behalf of its favored industries. Targeted industries are sheltered by a variety of import controls, both comprehensive and selective. Domestic growth of domestic industries has been promoted by tariff walls, discriminatory taxation, procurement policies, screening of foreign investment, and through state-owned bank lending.

Copper.— The conflict between trade policy and debt considerations is particularly well illustrated by the U.S. copper mining industry's recent petition for relief under section 201, or the escape clause. It may be recalled that despite the ITC's unanimous finding of serious injury to the industry from imports, the President ultimately denied import relief.

The copper case presented many difficulties for the Commission. Once we unanimously agreed that the industry met the statute's injury criteria, we then had to devise a remedy. The law gives us a choice of three alternative rememdies: trade-adjustment assistance, tariffs, or quotas. However, future funding of TAA is uncertain. Also, both tariffs and quotas threatened to create a two-tiered price system in which the U.S. copper price would have been higher than the world price. This would have hurt the copper fabricators and, ultimately, U.S. copper producers.

1 Foreign Industrial Targeting And Its Effects on U.S Industries, Phase III: Brazil, Canada, The Republic of Korea, Mexico, and Taiwan USITC Publication 1632, January 1985.

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A close examination of the facts regarding the U.S. copper industry's troubles would reveal it to be among the world's highest cost producers. The global market for copper has dictated a world price beneath U.S. production costs. But the ITC cannot by law make a recommendation to reduce global production that the domestic industry contends is needed for it to remain in business. Thus the Commission offered a split recommendation, with two Commissioners favoring tariffs and two favoring quotas.

In any event, debtor country problems were not a factor in the Commission's analysis. Such considerations apparently were important to the President, however. According to then-Trade Representative William Brock, high-debt copper exporters such as Chile and Peru urgently needed the earnings from increased copper exports to service their debts. Chile depends upon copper for 60 percent of its exports while for Peru the figure is 35 percent. So the U.S. would have further compounded the debt burdens for these countries by limiting access to a vital U.S. market in the one commodity these economies depend upon most heavily for their export revenues.

Countertrade.--Countertrade is another area where conflicts have arisen between U.S. trade policies and concern over the debt problem. Partly as a result of foreign exchange scarcities brought on by indebtedness, some developing countries have sought to conserve valuable hard currency by requiring counterpurchase agreements tied to merchandise imports from trading partners. Brazil claims that most of its oil imports during 1985 were financed by countertrade that satisfied mutual needs. However, countertrade involves barter that can leave the exporter acquiring merchandise for which it

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has no immediate use. As many U.S. firms do not have the extensive commercial links needed to market these goods, they usually exhibit reluctance towards countertrade. Additionally, foreign-made products that are imported to fulfill countertrade obligations may harm U.S. industry. However, a recent ITC study concluded that such imports comprise less than 3 percent of U.S. trade.

These foregoing have been examples of debtor country policies that hurt U.S. trade interests. Let me now give an example of debtor countries policies that can promote their growth without relying on restrictive trade measures.

One example of what can be accomplished when debtor countries remove restrictive trade practices can be found in Mexico's Border Industrialization Program. Under this program, exemptions from laws prohibiting foreign ownership of factories are granted when production is destined for export. In recent years such factories, or maquiladoras, have flourished, with U.S. firms being the largest beneficiaries. Under items 806.30 and 807.00 of the U.S. tariff code, duty-free treatment is accorded to imports on the value of U.S. parts or materials sent abroad for processing or assembly. This enables U.S. firms to reduce overall production costs and improve price competitiveness in final products on domestic and foreign markets alike.

For Mexico, the success of the maquiladoras have been a welcome source of economic optimism. By 1985 foreign exchange earnings from maquiladoras totalled $1.3 billion, surpassing tourism, and behind only petroleum, as a source of export receipts. For Mexico they may also be an important channel for the flow of foreign technology and managerial expertise.

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Conclusion

To conclude, current attempts to solve the debt problem have led to policies in debtor countries that shut out U.,S. exports and encourage increases in imports into U.S. markets. Existing remedies for exporters and industries like copper that compete in world markets distorted by the debt problem should be strengthened. For those industries suffering from greater import competition, the import relief system administered by the ITC provides an avenue for injured U.S. industries to seek relief. But relief under this system poses, if you will, a zero-sum situation, with gains to domestic industries coming at the expense of debtor nations' exports.

All of this points to the need for a more comprehensive solution to the sovereign debt problem. I am not an expert on international financial matters, and I will defer to those who are in devising specific proposals. My purpose today is to reinforce the need for a solution that does not embody the conflict between U.S. and debtor interest. One comment I will make, however, is that to the extent that it is feasible, the new policies should encourage internal economic reforms in the debtor countries. While the austerity programs have led to significant government interventions in foreign trade, many of these countries had long histories of policies to encourage import substitution and export development. Programs to assist these countries to meet their debt servicing needs may offer a unique opportunity to achieve a less restrictive environment for trading.

This concludes my testimony. I would be pleased to answer any questions you may have.

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Chairman LUNDINE. Thank you.
Mr. Wolff.

STATEMENT OF ALAN WOLFF, FORMER U.S. DEPUTY TRADE REPRESENTATIVE COUNSEL, SEMICONDUCTOR INDUSTRIES ASSOCIATION, PARTNER, DEWEY, BALLANTINE, BUSHBY, PALMER, AND WOOD

Mr. WOLFF. Thank you, Mr. Chairman, members of the subcommittee.

I have a strong personal interest in the subject that is before you today. Before being at the U.S. Trade Representative's office and Deputy Trade Representative in the Carter administration, I served for 5 years in the Treasury as counsel to the National Advisory Committee on International Financial and Monetary Policies, the inter-agency committee that is charged with reviewing U.S. policy toward the multilateral development institutions and monetary institutions.

This hearing could not come at a better time and the proposal could not be more timely. There has been too little interest in the subject of debt. It is too late in many ways for many American industries and for many developing countries. But much remains to be done to avert further hardship for both.

It is worth a word on the role of the Congress. I don't think there would have been a first Baker initiative had it not been for the Congress' interest in the impact of economic policies on trade. There would not have been a September agreement on monetary exchange rates had it not been for the Congress' activities last year, particularly the Rostenkowski-Gephardt-Bentsen bill, which brought to the administration's attention quite forcefully that some action was needed with respect to the value of the dollar.

This subcommittee is now focusing on what might become the Lundine initiative, although chances are someone in the administration will be found to place his or her name on it. I think an initiative is vital for the national interest. This is the second aspect of the international economic system, the first being the trading rules, the second, development finance, and the third, the international monetary system.

These are not working well.

This hearing is about debt and its linkage to trade and, again, Mr. Chairman, you are to be congratulated because it is most timely, indeed.

American industry and labor have gone through 3 very devastating years on the trade front. The cumulative red ink from trade since 1983 has approached $350 billion. The causes have been seen primarily and necessarily in terms of the strong dollar, our own Federal budget deficits, and faster growth here than in other countries, but too little attention has been paid to the trade ramifications of the way in which international debt obligations of the developing countries have been managed or have not been managed.

Mr. Chairman, again, you are to be commended for addressing the continuing international debt problem and the implications for both the country's broad national interests in terms of its economy and our political foreign policy interests, our military interests, as well as our commercial interests.

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Let me start with some background. The international economic system consists of the international trading rules in the GATT, the World Bank's and its sister institutions' assistance to developing countries and the International Monetary Fund, which was designed to insure that temporary balance of payments problems did not lead to a contraction of trade because of an inability to obtain foreign exchange.

Today, we have let ourselves get into a position where the international financial system is stifling trade, especially in the developing world, rather than fostering it. This has occurred through a failure of leadership, not as a result of any intentional policy.

The international economic position of the United States has undergone significant changes in the decade of the 1970's. Our exports from 1978 to 1981 grew by 63 percent. But it is important to note that the growth in U.S. exports accounted for by the developing countries during that period was 73 percent, and to the Latin American region, which grew faster than to any other region, our exports grew by over 91 percent in just that short period, 1978-81. Our exports thus almost doubled to Latin America.

In 1982, we saw the end of this period. The impact of the debt crisis was felt. Restructurings were handled on a case-by-case basis with little apparent regard for the cumulative impact on world trade in general or U.S. trade in particular.

In 1982, U.S. exports to Latin America fell by 20 percent. In 1983, by another 24 percent. In absolute terms, the largest decline in 1982 was to Mexico, some $6 billion and in percentage terms, very large declines with Argentina, down 41 percent, and Chile, 40 percent.

Let me turn for a moment to the experience of some individual companies because it is, in fact, something that we often forget when we talk in these broad terms. Trade balances mean jobs. They mean an impact on individual companies, employment in particular Congressional districts.

The impact of debt on Latin America for just one company that I spoke with this week, Westinghouse, was dramatic. From 1981-85, Westinghouse orders entered from all Latin American countries fell precipitously by over half. Billings dropped by about 50 percent as well. Westinghouse management states that there is no question but that the debt service burden of the Latin American countries during this recent period has depressed the sales to these countries, deprived them of the financial resources to purchase equipment and components from Westinghouse and other suppliers.

Clearly, when one looks at the manufacturing of fiber optics or even the copper cable that was involved as a downstream product in the copper case, employment in New York State was affected by the economic contraction, the absence of building telecommunications systems in Latin America and elsewhere in the developing world.

If you look to Florida, Harris is the largest manufacturing entity in the State of Florida. One large component of its business was the sale of satellite ground stations.

I say "was" because the drying up of development funds, of resources, has made that business extremely depressed.

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This is not a falling off in demand for services. There's still a need for telecommunications in Latin America. There is still a need for heavy electrical generating equipment throughout the developing world. It is the inability to buy.

For Brazil, U.S. exports declined over 25 percent in the last 4 years, for the year 1985 over 1981.

For Mexico, the decline just for 1983 compared with 1980 amounted to a $9 billion annual rate. It was $6 billion if you take the annual rate for the year 1985 over 1981.

This was not due to the exchange rate. Our share in the Brazilian and Mexican markets was maintained—viewing United States versus foreign competition. It was caused by an economic contraction, a shortage of foreign exchange. In fact, their debt crisis was our trade crisis.

Let me address now for a moment or two the choices before us.

Today, the economic policies being chosen are curbing the growth in the world's poorer nations. Interest on external debt has risen to extreme levels. And in the last few years, there has actually been an inflow of capital from these poorer countries to the United States.

The function of the international financial system seems to have become inverted. In the 1970's, the international financial system existed to finance trade and development. In the 1980's, trade seems to exist to a large degree to service the debt accumulated during and up to the 1970's.

As a result, the growth of developing countries has been curtailed and a great source of the growth in world prosperity during the 1960's and 1970's has been prevented from performing this role in the 1980's.

This state of affairs does not serve our economic interest. It does not service our strategic interest. Nor does it serve the cause of world peace.

In my view, it is futile to build up American capabilties to move troops quickly to all sections of the globe if our policies toward the financing of world development falls so far short of what is needed. We are destabilizing the very democracies that we intend to support and help.

So it is in our national economic and strategic interests and of the interests of the western industrialized democracies to find a way for the developing countries to resume a healthy rate of expansion without reverting to short-sighted lending and borrowing policies that characterized the 1970's.

To draw this most sharply, our approach to debt has been closer to the Dawes plan and the Young plan of 1924 and 1929 to the vanquished in World War I than to the Marshall plan of 1947.

Regrettably, the debt issue has not been sufficiently high on the international agenda and it is my hope that this draft legislation being considered before this committee today can be an important factor in bringing this issue to its proper place in the councils of not only our own government, but the international economic organizations in which we are members.

Let me turn specifically to the Lundine proposals, if I might.

I am not here to comment technically on the financing proposals, although I believe that it is essential to increase the flow of finan-

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cial resources to the developing countries and that this is probably best done through an increase in the bank's capital base. And Bill Cline and others have testified extensively on that subject.

I do wish to address with greater particularity the section of the bill which draws the linkage between trade and debt, first, by increasing World Bank loans to developing countries, only where trade liberalization is occurring, or primarily where it is occurring, and second, encouraging trade surplus nations to increase imports from debtor countries.

First, the idea of increased conditionality, in my view, is an extremely good one. I have often felt over the years that the GATT and the fund and the bank should work much more closely together than is today the case, that GATT members should go along with fund delegations and bank delegations in annual reviews of countries' programs, in the trade area as well as in other economic areas.

A number of the largest debtors, such as Mexico and Brazil, have also been countries where the government has followed highly interventionist economic policies, generally protectionist in nature—import substitution, infant industry protection, investment performance requirements, and highly restrictive import regimes.

Conditioning increased lending to these countries, especially as regards structural adjustment loans from the World Bank, can bring additional pressure to alter economic policies that are harming these countries own economic development and the U.S. exports.

The process of lending should not only provide, however, leverage for the adoption of well-founded policies, but should be used as a means of making effective trade liberalization possible.

In other words, there is a link to the new round of negotiations.

I also agree with the objective of getting other developed countries, the industrialized countries especially the surplus countries, to buy more, to increase their imports of products from the developing nations, particularly manufactured goods.

Surplus countries could help by increasing their imports from Mexico and other debtor countries, ranging from textiles, clothing, steel, and electronics, to motor vehicles. I would not personally place great stress on oil as a primary import to be concentrated upon from these countries.

The United States, as Bill Brock was fond of quoting, takes some 60 percent of the manufactured exports of the developing countries. We take some 72 percent of the clothing exports of developing countries. We are doing more than our fair share. Japan and the European community and other developed countries have to do more.

Let me take a moment on the new round.

I think the new round will be self-balancing by itself. Developing countries will benefit from greater transparency in the imposition of trade-restricting safeguard actions from greater access to government procurement, from better rules for agricultural trade, for an opportunity to make dispute settlement processes increase the leverage of smaller countries, allowing them to prevail when they have right on their side.

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However, what is so attractive to these countries about open, nondiscriminatory trading arrangements when, in fact, their ability to import is choked off through the absence of financial resources?

Most developing country markets are limited more by financial constraints than by the appalling morass of import restrictions and trade-distorting measures that result from misguided national economic planning.

Therefore, no new GATT round can be a full success and have full participation of the developing countries without attention to debt finance.

That's not an excuse for the developing countries to take extremely distortive measures in particular sectors, but simply the realization that these markets will not be substantially better markets for us without attention to increased financial flows from the developed countries.

That concludes a summary of my prepared remarks. I will be happy to answer any questions that you or the other Members of the subcommittee may have at the appropriate time.

[The prepared statement of Mr. Wolff with attachments follows:]

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STATEMENT OF

ALAN WM. WOLFF
PARTNER
DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT
INSTITUTIONS AND FINANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

ON

DEBT AND TRADE:
CHOOSING GROWTH OVER STAGNATION

THE IMPLICATIONS OF THIRD WORLD DEBT FOR THE INTERNATIONAL TRADING SYSTEM

MARCH 19, 1986

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STATEMENT OF

ALAN WM. WOLFF
PARTNER
DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD
BEFORE THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT
INSTITUTIONS AND FINANCE
MARCH 19, 1986

Mr. Chairman, the international economic system -- consisting of three interdependent spheres, the trading rules, trade and development finance institutions, and international monetary institutions -- is not working well. Thus this hearing on the linkage between international debt and world trade could not be more timely. It is the Congress which is today acting as an important catalyst to a change in the direction of American policy. It was last year's trade proposals, although extreme (and in large part because they were seen as extreme), which stimulated five governments to move to a realignment of currencies. And it may well be your draft bill, Mr. Chairman, which causes a basic rethinking of American policy toward developing country debt.

The perspective which I bring to this subject derives primarily from my experience in international trade negotiations and policy, as former Deputy U.S. Trade Representative in the Carter Administration and now as one actively representing many American clients having a strong interest in international trade. Prior to this period, however, from 1969 to 1972, I served at the U.S. Treasury as staff counsel to the National Advisory Committee on International Monetary and Financial Policy, the group charged with overseeing the lending policies of the international financial institutions for the United States. My observations draw on that period as well.

American industry and American labor have gone through three very devastating years on the trade front, with the cumulative trade deficits since 1983 approaching $350 billion. The causes behind these large trade deficits have been seen primarily and necessarily as the strong dollar, our own federal budget deficits, and faster growth here than in other countries. Too little attention has been paid to the trade ramifications of the way in which the international debt obligations of the developing countries are managed. Mr. Chairman, you and the members of your subcommittee are to be commended for taking the initiative in addressing the continued international debt problem, including both the implications for this country's broad economic interests and its commercial interests as well. The Con-

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gress's initiative in trying to advance solutions to our international economic problems should be welcomed both at home and abroad.

BACKGROUND

The GATT and the international financial institutions established after the second world war were meant to provide the institutional basis for expanding economic prosperity through world trade. The GATT rules were designed to lower existing barriers to trade, primarily in the form of tariffs and quotas, and to control and minimize the establishment of any new trade restrictions. The International Bank for Reconstruction and Development -- or World Bank -- was initially set up to provide international financial flows to enable war-devastated countries to have sufficient capital to reconstruct their economies. The International Monetary Fund was to ensure that temporary balance of payments problems did not lead to a contraction of trade because of an inability to obtain foreign exchange. As in our domestic economy, the international financial institutions and structure were designed to facilitate trade in real goods and services.

Today we have let ourselves get into a position where the international financial system is stifling trade in goods and services, especially in the developing world, rather than fostering it. This has occurred through a failure of leadership, not as the result of any intentional policy.

The international economic position of the United States underwent significant changes in the decade of the 1970s. A key indicator of these changes was the increase in the share of exports and imports in our country's Gross National Product (GNP). Imports expanded rapidly, but so did exports. By the end of the decade the developing world was the fastest growing market for U.S. exports (see table 1). From 1978 to 1981 U.S. exports to the world grew by 63%. However, the growth accounted for by the industrial countries was only 57% while the growth in U.S. exports accounted for by developing countries was 73%. Among the developing countries, exports to Latin America grew faster than to any other region -- by over 91%. In these three years, 1978-81, U.S. exports to Latin America almost doubled.

Then in 1982 this growth abruptly stopped as the impact of the debt crisis was felt. Mexico was the first developing country to announce that it could not meet the debt service obligations it had accumulated during the 1970's. Since then, a significant number of other countries, some of them major markets for U.S. exporters, have had to have a

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major "restructuring" of their international debt obligations to avoid default. Up to the present time these restructurings have been handled on a case-by-case basis, and with little apparent regard for the cumulative effect on world trade in general, or U.S. trade in particular. In 1982 U.S. exports to Latin America fell by 20% and in 1983 exports fell another 24%. In absolute terms, the largest decline in 1982 was in U.S. exports to Mexico ($6 billion), but in percentage terms the largest declines were to Argentina (-41%), and Chile (-40%).

The rapid erosion of the U.S. trade position with Latin America (where most of the debt burden is concentrated) was mirrored by the equally rapid reversal in the U.S. capital account with Latin America. The net turnaround in U.S. capital flows to Latin America from 1981 to 1984 was $33.7 billion, going from a net outflow to Latin America of $19.9 billion in 1981 to a net inflow from Latin American of $13.8 billion in 1984 (see table 2). The deterioration in the U.S. trade balance with the region from 1981 to 1984 was $21.7 billion, moving from a surplus in trade of $1.3 billion in 1981 to a trade deficit of $20.4 billion in 1984.

It is sometimes forgotten that the trade account consists of products -- made by companies and their workers. Let us take just one example. The impact of debt on Latin American countries has severely depressed their ability to purchase electrical products from Westinghouse. From 1981 to 1985 Westinghouse orders entered from all Latin American countries fell precipitously -- by over half. Billings also dropped by 50%. Westinghouse management states there is no question but that the debt service burden of Latin countries during the recent years deprived them of the financial resources to purchase equipment and components from Westinghouse and other U.S. suppliers.

There are countless other examples. Some in each Congressional district. When new telecommunications systems are not built in the cities of Latin America, less optical fiber is made in Corning, New York, and less copper cable in Rome, New York, or in Indianapolis. Fewer switches are made in a half dozen different locations. When satellite ground stations are not installed abroad, there is less employment in Melbourne, Florida, and less microwave equipment produced in the nearby hills of Maryland.

This loss of production, and of jobs, is not due to any misalignment of exchange rates, for U.S. share has been maintained in these markets, but by an economic contraction caused by a shortage of foreign exchange. It is caused in large part by a failure of the international financial system to sustain economic growth in Latin America. This debt crisis is thus not remote, a matter for concern only in

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foreign countries. In a very real sense, their debt crisis is our trade crisis.

THE CHOICES BEFORE US

Whether one approaches the challenge of today's international financial problems with the extraordinary vision of those at Bretton Woods, shaping a new world of development and reconstruction, or views America's political, military and economic interests strictly in current national terms, the necessary responses are fundamentally the same. We can choose either to allow financial arrangements to stifle trade or we can establish the type of financial arrangements that will facilitate trade and expand the world economy. Clearly, it is imperative that we choose the path of growth.

It has long been the objective of American policies to promote the cause of democratic government throughout the world. We could not long survive as a single democracy in a sea of world communism. One of the strongest factors supporting our cause is that poverty breeds communism. It produces want while a working free market system produces well-being, supporting maintenance of political freedom.

Today the economic policies being chosen are still curbing growth in the world's poorer nations. Interest on external debt has risen to extreme levels, and, in the last few years, there has been an actual inflow of capital from these poorer countries into the United States. The function of the international financial system seems to have become inverted. In the 1970's, the international financial system existed to finance trade and development. In the 1980's, trade exists to a large degree to service the debt accumulated during and up to the 1970's. As a result, the growth of developing countries has been curtailed and a great source of growth in world prosperity during the 1960's and 1970's has been prevented from performing this role in the 1980's.

The developing countries were loaned vast sums of money, particularly during the 1970's. Their total foreign debt rose precipitously, from $75 billion in 1970 to ten times that amount in 1985. Interest payments have become a dominant factor in these countries' external accounts. The rapid rise in real interest rates combined with slow growth and depressed commodity prices have joined forces to create the debt crisis of the 1980's.

Although measures have been taken to assist the developing countries in meeting their obligations, particularly the very recent general reduction in the level of interest rates, the situation remains an extremely serious one. Total foreign debt of the developing countries continues to

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rise. Large portions of the increased indebtedness is used to service the debt itself. The private banking system is no longer willing or able to transfer the needed resources to the developing countries. At the same time, the industrialized countries have reduced the degree of support needed for the multilateral financial institutions, and the IMF has been used for preaching fiscal austerity.

In part, because of these policies toward debt repayment, and in part because of fiscal and monetary policies, capital is currently flowing into industrialized countries, particularly the United States, and away from developing countries. This is serving not only to slow the economic growth of the developing countries and to make it increasingly difficult for them to meet their debt obligations; it is curbing the rate of growth of world trade as a whole. It is adversely affecting the prosperity of the United States and many other nations, and is limiting industrialized country exports generally.

This state of affairs serves neither our economic nor our strategic interests, nor does it serve the cause of world peace. It is futile to build up American capabilities to move troops quickly to all sections of the globe if our policies toward the financing of world development fall so far short of what is needed as to destabilize democracies around the world. Each year, in the course of our national budget consideration, we should ask the question: What is the sense of stockpiling arms to deal with a hostile world environment, while at the same time sowing the seeds of discontent and revolution that make the use of arms ever so much more likely? It is clearly in the economic and strategic interests of the United States and the Western industrialized democracies to find a way for the developing countries to resume a healthy rate of expansion without reverting to the short-sighted lending and borrowing policies of the 1970's.

We made a fundamental error after World War I in the treatment of debt. This was one of the major causes of World War II. We did not repeat those failed policies in the aftermath of that second war. Instead, in 1947, we adopted the Marshall Plan. We don't feel capable of doing that today. In fact, our treatment of debt today much more closely resembles the Young Plan of 1929 than the Marshall Plan. But as Santayana said: "Those who cannot remember the past are condemned to repeat it." What we are doing today with respect to development finance -- or more accurately, what we are failing to do -- is causing extraordinarily serious problems, both for ourselves and the developing countries. Regrettably the debt issue has not been sufficiently high on the international agenda. There have been some steps taken in the right direction, but they have been halting, and have not gone far enough. Perhaps the

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draft legislation being considered here can be an important factor in according this issue its proper place in the councils of international economic organizations and of their member governments.

THE LUNDINE PROPOSALS

This subcommittee is considering legislative proposals advanced by the Chairman to assist with the attainment of objectives put forward by Secretary Baker in Seoul, South Korea last Fall. I am here less to comment technically on the financing proposals in the legislative package, as I am here to plead the cause of increasing the flow of financial resources to the developing countries. However, I believe that it would probably be best to do this by increasing the capital base (primarily using callable capital) than to affect the financial rating of the World Bank by increasing the gearing ratio of the Bank or to change the way in which U.S. commercial banks account for their international lending. Corollary actions are also required. The United States can still further assist these debtor countries by getting U.S. dollar interest rates down -- recent trends are encouraging -- and by getting other developed countries (the EEC and Japan) to take in more of developing countries' exports of manufactured goods, even in sensitive product areas such as steel and textiles and clothing.

This brings me to the area of the Lundine bill that I do wish to address particularly -- the section on the linkage between trade and debt. This section of the bill has two basic parts: (1) increasing World Bank loans to developing countries where trade liberalization is occurring -- that is, requiring an element of trade conditionality; and (2) encouraging trade surplus nations to increase imports from debtor countries.

The idea of utilizing some degree of trade liberalization conditionality is a good one. A number of the largest debtors, such as Mexico and Brazil, have also been countries in which the government has followed highly interventionist economic policies that have generally been protectionist in nature -- favoring import substitution and infant industry protection, and employing investment performance requirements, and highly restrictive import quotas. Conditioning increased lending to these countries, especially in connection with structural adjustment loans from the World Bank, can bring additional pressure to bear on them to alter economic policies that are harming their own economic development, and, coincidentally, U.S. exports.

It is not that developing countries can afford to abandon import restrictions completely, but certainly the trade-distorting effects of these measures can be ameliorated.

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One of the greatest enemies of the expansion of international trade is uncertainty, bred, for example, from haphazard import licensing decisions or arbitrary investment requirements. The futures of the intended beneficiaries of Bank lending are heavily dependent on the growth of trade and private investment. Thus it is fully legitimate for the GATT Secretariat to lend its expertise to Bank/Fund missions in an attempt to improve the trade and investment climate in the recipient countries. This degree of conditionality would be a well-conceived addition to the international financial system. (It should also include a commitment from the more advanced developing countries to accept more of the manufactured products of the lesser developed countries).

The process of lending should not only provide leverage for the adoption of well-founded policies, but should also be used as a means of making effective trade liberalization possible. It is worth mentioning in this connection the new GATT round and what the developing countries might get out of it. All countries, developed and developing alike, will benefit from several of the proposed codes -- greater transparency in the imposition of trade restricting safeguard actions, greater access to government procurement, better rules for agricultural trade, an opportunity to make dispute settlement processes work for smaller countries as well as the larger. In other words, the new Round will be likely to be internally self-balancing from the developing countries' point of view.

But what is so attractive to these countries about open, non-discriminatory trading arrangements when trade itself is choked off through the absence of financial resources? Most developing countries' markets are limited more by financial constraints than by the appalling morass of import restrictions and trade distorting measures that result from misguided national economic planning, however devastating these policies may be. Thus, no new GATT round can be a full success, nor have full developing country participation, absent a very large improvement in the treatment of debt in the international economic system.

The next objective of the draft legislation of the legislation to get other industrialized countries, especially those with large global trade surpluses (e.g. Japan and Germany) to increase their imports of products from the developing nations. The United States already accounts for over 60% of purchases of developing country exports of manufactured goods. I thoroughly support this objective, broadly stated.

The proposed bill specifically mentions oil, however I am not convinced that it would be very helpful for the industrialized countries to switch from buying oil from Kuwait or Iran to buying oil from Mexico. The problem for these

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countries is primarily the low world price for oil. The only way to correct this from these countries' point of view is to reduce supply in relation to demand. Clearly this we could not advocate. An increase in oil prices would curb world economic growth to the detriment of developing countries generally.

The benefits to the international economy from lower oil prices are extremely positive. A preferred approach would be for Mexico to diversify its export sector and internal development away from its crucial dependence on the oil sector. Surplus countries could help by increasing their imports of other products, with emphasis on manufactured goods, from Mexico and the other debtor countries. These purchases could range from textiles, clothing and steel to electronics and motor vehicles. Trade liberalization on the part of the OECD countries, and the more industrialized developing countries, should be a principal part of any approach to promoting a general increase in the rate of global economic growth.

Finally, as the Lundine bill proposes, the Multilateral Investment Guarantee Agency (MIGA) now in the process of being adopted, deserves American support. It can help to keep capital flowing into the developing countries. However, the developing countries will have to change their own policies that restrict or distort investment before guarantees will reach their full potential. Another proposal along these same lines that you might want to consider is a multilateral export credit agency. Direct trade finance is extremely important, especially for debt-burdened developing countries, and should be part of a general approach to the debt/finance question. It is ironic that the United States is cutting back on Eximbank loans at a time when they could be of the most use to developing countries and our own exporters.

CONCLUSION

Mr. Chairman, that concludes my prepared remarks. I would be happy to answer any questions that you or other members of the Subcommittee may have.

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TABLE 1

U.S. EXPORTS 1978-1984

	1978	1979	1980	1981	1982	1983	1984
WORLD	143.8	182.0	220.8	233.7	212.3	200.5	217.9
Industrial Countries	82.6	106.7	125.4	129.7	117.2	117.6	130.4
Developing Countries	54.9	66.1	86.9	94.9	86.9	75.4	78.2
Africa	4.2	4.9	6.5	7.9	7.0	5.6	5.9
Asia	12.1	17.1	23.8	23.0	23.8	23.7	25.1
Latin America	22.0	28.5	38.7	42.1	33.6	25.7	29.7
Other	16.6	16.2	18.4	21.9	22.5	20.4	17.5
Argentina	0.8	1.9	2.6	2.2	1.3	1.0	0.9
Brazil	2.9	3.4	4.4	3.8	3.4	2.6	2.6
Chile	0.7	0.9	1.4	1.5	0.9	0.7	0.8
Mexico	6.7	9.9	15.1	17.8	11.8	9.1	11.9
Peru	0.5	0.7	1.2	1.5	1.1	0.9	0.8
Venezuela	3.7	3.9	4.6	5.4	5.2	2.8	3.4

SOURCE: International Monetary Fund, Direction of Trade Statistics

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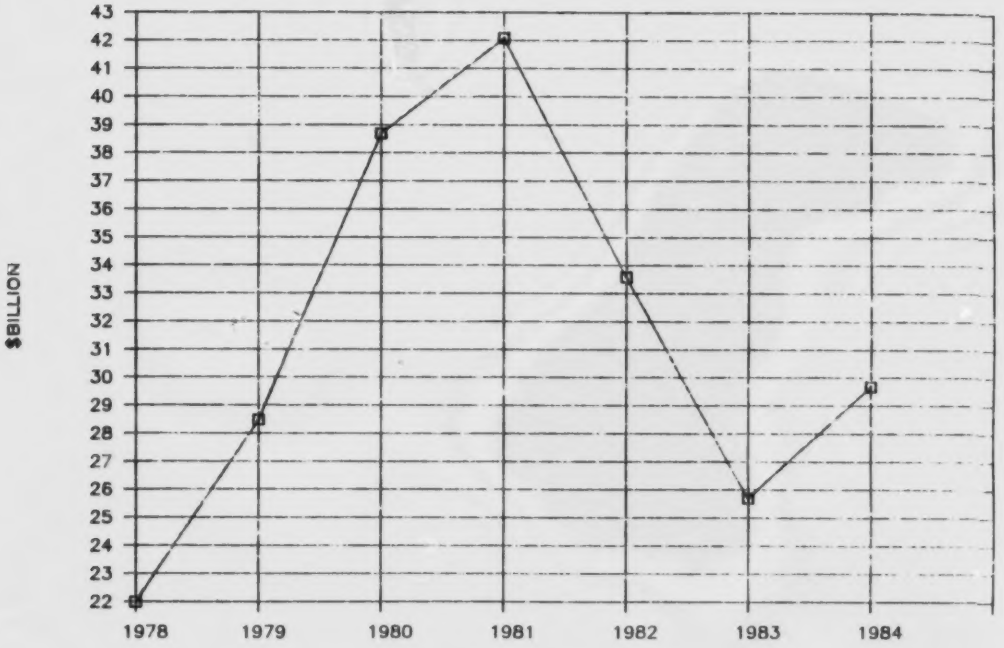
U.S. EXPORTS TO LATIN AMERICA 1978–1984



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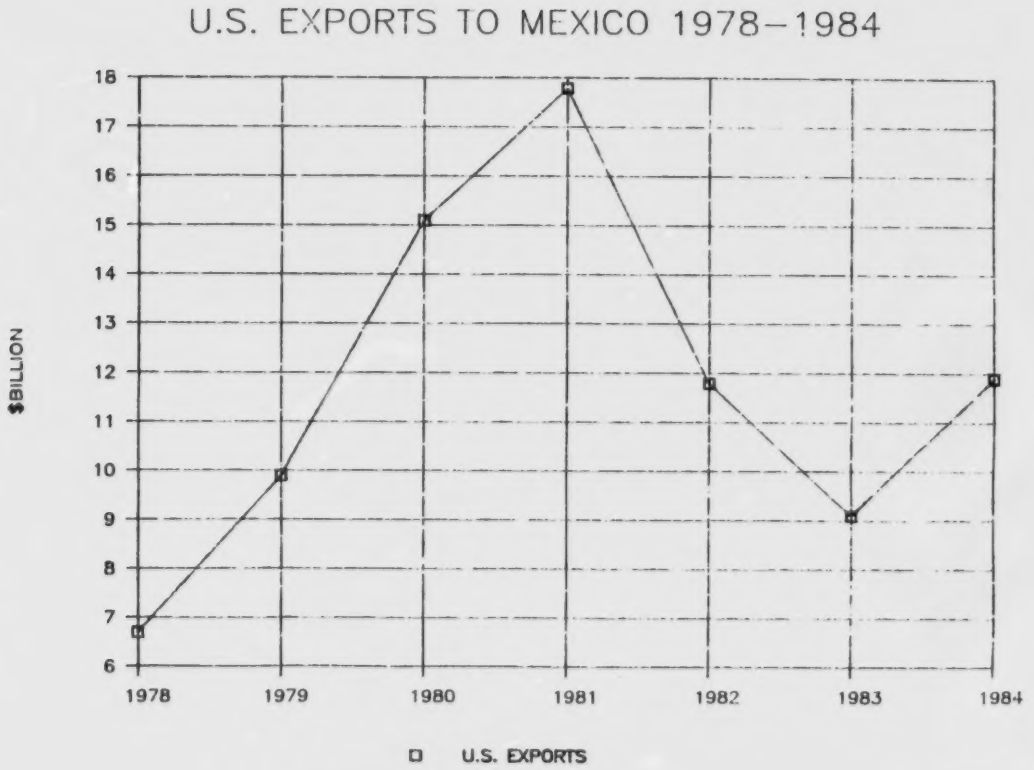

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U.S. EXPORTS TO ARGENTINA AND CHILE

1978–1984

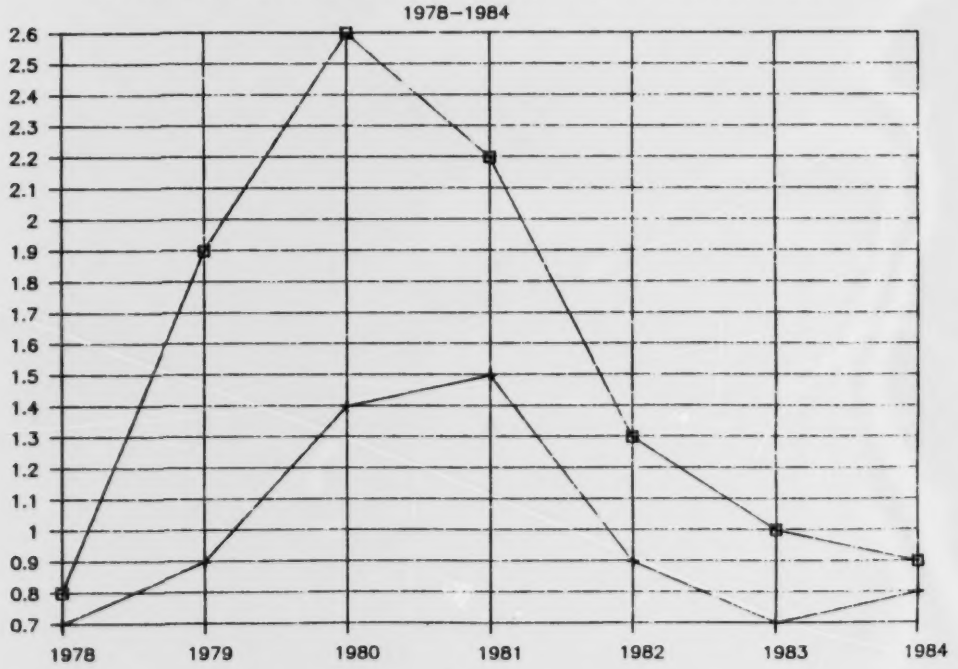

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TABLE 2

U.S. CAPITAL ACCOUNT
NET FLOWS TO LATIN AMERICA

	1979	1980	1981	1982	1983	1984
Capitol Inflows	19.9	8.8	32.3	31.1	27.7	19.7
Capital Outflows	-14.9	-32.4	-45.1	-46.6	-13.4	3.6
Statistical Discrepancy	-12.2	11.2	-7.1	7.1	-6.7	-9.5
Net Capitol Flows (- is outflow, + is inflow)	-7.2	-12.4	-19.9	-8.4	7.6	13.8

Source: Survey of Current Business (various issues)

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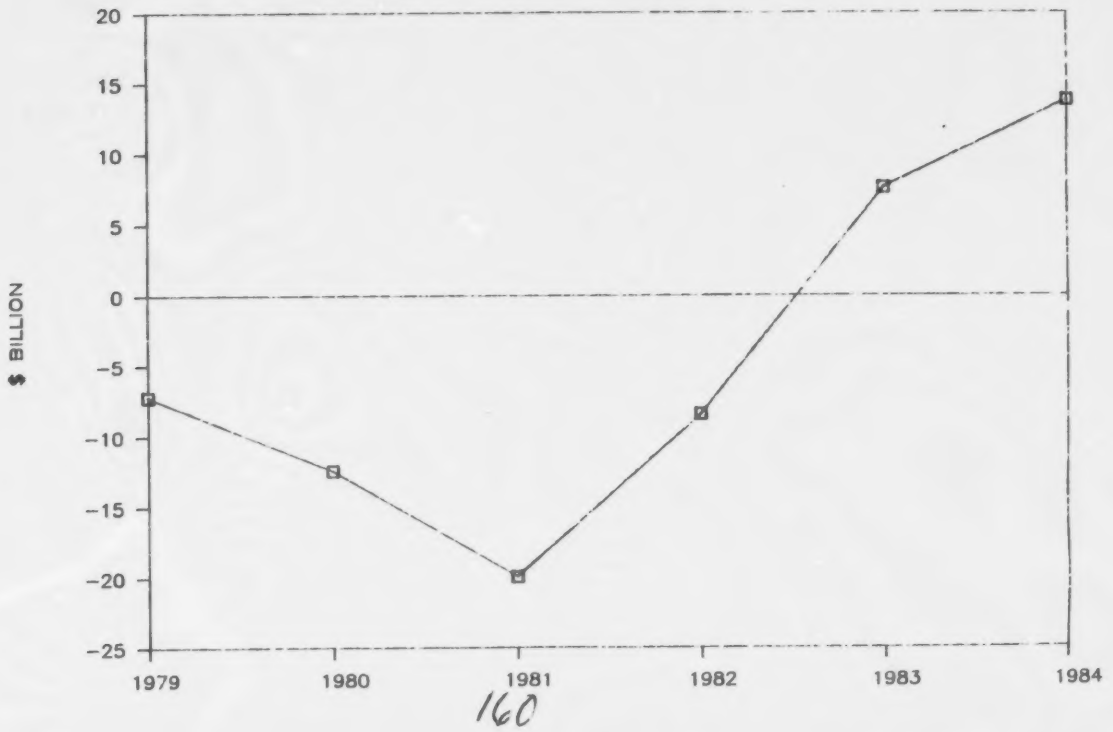
U.S. NET CAPITAL FLOWS TO LATIN AMERICA



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Chairman LUNDINE. Thank you.
Mr. Tucker.

STATEMENT OF STUART K. TUCKER, FELLOW, OVERSEAS DEVELOPMENT COUNCIL

Mr. TUCKER. Mr. Chairman, thank you for inviting me to testify. My views are my own and should not be construed as reflecting the opinions of my colleagues or the board of directors of the Overseas Development Council.

The general perception within the commercial banking community is that the year 1985 was another year weathered without a debt disaster, yet another disaster continues in the U.S. economy. A conservative estimate is that the United States lost an additional 200,000 jobs in 1985 due to continued decline in U.S. exports in developing countries.

Clearly, there are costs to the U.S. trade sector due to the debt crisis.

The U.S. trade deficit with the developing countries is largely due to the burden of debt and the weakness of world growth. Of course, some of our developing country partners, have, indeed, contracted imports and promoted their own exports using subsidies and barriers.

For the most part, these offenders are developing countries that are suffering from debt crisis. Despite the recovery experienced in the Third World in 1984-85, U.S. exports to developing countries did not recover as fast as U.S. exports to other countries.

In 1984, U.S. exports to developing countries rose only 2.6 percent from the 1983 level, which is actually a slight fall in real constant dollar terms. Exports to the rest of the world, however, in that year rose 12.3 percent.

In 1985, the story didn't change much. U.S. exports to developing countries actually fell 4.5 percent, while exports to the rest of the world fell only 0.6 percent.

U.S. exports to developing countries also declined more than others during the 5-year period between 1980 and 1985. U.S. exports to debt-strapped Latin America have fallen nearly 31 percent. Further, U.S. exports to 21 developing countries heavily burdened with debt fell by 31.3 percent in real terms between 1980 and 1984.

It should be no surprise to us that debt has had a major impact on U.S. exports. Six major Latin American debtors have reduced total imports from the world by 33.5 percent during the 1980-84 period. In the same period, imports from the world by developing countries with debt service problems fell by 43 percent in real terms.

Now this loss of export markets for the United States has meant a loss of jobs. The decline of our exports to developing countries in the period, 1980-85, has had a significant impact. In 1985, the United States had 632,000 fewer jobs due to this decline of exports to the Third World since 1980. Additionally, another 930,000 jobs have been lost which would have been created if trade had continued along the path from the 1970's through the 1980's up until now.

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Thus, combining the two, nearly 1.6 million jobs have been lost due to the recent recession in the Third World, much of which can be attributed to the debt crisis.

This 1.6 million represents nearly 19 percent of U.S. official unemployment in 1985.

Within these losses, the manufacturing sectors have been most severely damaged. Generally, aircraft, motor vehicles, transportation equipment, and power-generating equipment industries have lost the most. The success stories have been relatively limited and usually to industries related to electronic computers and office machinery.

My written testimony provides more detail on that, as well as some of the writings that I would be happy to supply people who ask.

There are a number of policy alternatives that the United States now faces on the debt crisis and these alternatives are coming to the fore right now because it is not just the banking community which is suffering. The U.S. economy, as I have just mentioned, is suffering significantly.

The result of the current approach has been to continue the significant risk to the international financial system while severely damaging U.S. industry and employment without reducing the present or future debt burdens weighing down the economies of the Third World.

Recently, we have had some changes in this approach, called the Baker initiative, and these certainly seem to give a chance of forestalling a major collapse of the system for the time being. Yet, the strategy does not provide any real light at the end of the tunnel. The main emphasis still is on austerity and policy reform in the Third World and the plan only provides small increases in new commercial lending, and this shows very little sign of materializing.

In the meantime, the debt continues to mount without any real prospect of diminishing in the future.

The policy alternative of debt relief is an option that implies losses for the banking community. However, the U.S. economy as a whole is already losing because of the debt crisis. The choice facing the U.S. Government now is one of how to reduce the overall loss to the U.S. economy and how to distribute the impact of these losses fairly.

The Baker plan does not go far enough toward finding a way of burden-sharing that is both fair and likely to reduce the impact of the losses.

There are two reasons why the Baker plan holds very little hope for a redistribution and reduction of the cost of the debt crisis.

First, the World Bank is intergovernmental. It is not independent of political pressures. It has not yet been designed to be the world's central banking authority. Significant changes in the way it functions would have to be affected to make the bank an effective debt mediator and these changes would have to be weighed against the potential for undermining the bank's present positive development role. Second, it is not in the interest of the commercial banks to seek a fair distribution of the cost of the debt crisis.

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Therefore, effective debt relief can only be carried out by active intervention by the United States and other industrial country governments, assuming that the Bretton Woods institutions are not radically altered.

There are a number of possible debt relief measures available to the U.S. Government which I have sketched out in my written testimony and will skip over right now.

Complementary to debt relief, a more activist approach to the Government to resolving the crisis should encompass the issue of appropriate and complementary trade policies in the United States and in other industrial countries, as well as in debtor countries.

The United States has to run a trade deficit with debtor countries if debt repayment is expected. U.S. trade policy would be amiss to expect rapid return to trade balance with debtor countries.

If the U.S. export sector is to revive, then total trade with debtor countries will have to increase. This is only possible in an expanding business climate. While parts of the Third World have undergone mild recovery in the last few years, growth prospects remain dampened by the austerity measures required to service their debts.

Current debt policies have advocated trade liberalization in debtor countries. The short-run impact of such would be to reduce the Third World's ability to run trade surpluses. Extreme liberalization measures within debtor countries at this point in time politically and economically endanger debt management policies.

Attempting to use the World Bank lending in a conditional way to rapidly alter the trade policies of debtor countries may lead to the ruin of debt management policy. A more appropriate global trade strategy that is complementary with the solution to the debt crisis should seek the opposite; that is, an expansion of the economies of the creditor nations.

If all three major industrial areas, the United States, Europe, and Japan, pursue open trade policies and sustained rapid growth, then the Third World will be able to significantly increase both its exports and its imports. Though the effect on the U.S. trade balance with developing countries may only be gradual, at least the expanding export markets abroad will help revive U.S. export industries and jobs.

Concern about the link between trade and debt issues in today's global economic environment is warranted. However, the cart must not be put in front of the horse. Financial considerations are the major barrier to U.S. trade with the Third World. Any attempt to rectify the U.S. trade deficit first will only exacerbate the debt crisis. Yet, providing debt relief will reduce the U.S. trade deficit in the long run and especially will help U.S. export industries. Debt management should be placed ahead of trade deficit reduction on the U.S. policy agenda with the Third World. Thank you.

[The prepared statement of Mr. Tucker follows:]

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STATEMENT OF STUART K. TUCKER

FELLOW, OVERSEAS DEVELOPMENT COUNCIL

before the

Subcommittee on International Development Institutions

of the

House Committee on Banking, Finance, and Urban Affairs

Washington, D.C.

March 19, 1986

* * * * * * * * * * * * * * *

Mr. Chairman, I wish to thank you and the subcommittee for inviting me to testify on the lingage between U.S. trade performance and the Third World debt crisis. The following views are my own and do not necessarily reflect the opinions of my colleagues at the Overseas Development Council or its Board of Directors. My remarks draw extensively from a study which I recently completed and published as an Overseas Development Council Working Paper entitled, "Update: Costs to the United States of the Recession in Developing Countries." Additionally, many of the ideas herein can be found in the ODC publications "U.S.-Third World Trade Deficit: Going After the Causes" by Stuart K. Tucker (ODC Policy Focus 1985, No. 7) and Uncertain Future: Commercial Banks and the Third World edited by Richard E. Feinberg and Valeriana Kallab (ODC Policy Perspectives, No. 2).

Congress is well aware of the magnitude of the debt which developing countries owe U.S. banks, not to mention the international financial

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system as a whole. The repeated headlines of country after country running into troubles paying back financial debts are hard to ignore.

The question that I would like to address at this hearing today is the costs to the U.S. economy of these financial problems overseas. More specifically, my remarks will focus on the performance of U.S. export industries over the period 1980 to 1985. This statement is organized into sections dealing with the export and job losses associated with Third World markets (for manufacturing, in particular), debt policy alternatives, and coordination of international trade policy with debt management.

TRADE COSTS OF THE DEBT CRISIS

The general perception within the commercial banking community is that the year 1985 was another year weathered without a debt disaster. Yet, a quiet disaster continues in the U.S. economy. A conservative estimate is that the U.S. lost an additional 200,000 jobs in 1985 due to continued decline in U.S. exports to the developing countries. Clearly, there are costs to the U.S. trade sector due to the debt crisis.

Since 1982, the U.S. trade deficit with the Third World has ballooned rapidly (see Table 1). The 1984 U.S. trade deficit with the Third World was a record-high $53 billion--an amount equal to 1.4 per cent of U.S. gross national product. Furthermore, the surplus in U.S. trade in services narrowed as a result of the decline of income from U.S. overseas investment, loans, and other services. Preliminary data on 1985

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trade indicates that the deficit with developing countries did not significantly change. The 1986 U.S. trade deficit with the Third World is likely to also be in the $50 billion range. If this proves to be true, the U.S. economy will have sustained three years of unequalled trade deficits with developing countries.

Table 1. U.S. Trade with Developing Countries
($billions)

	U.S. Exports	U.S. Imports	Trade Balance
1980	84.2	123.0	-38.8
1981	92.4	125.3	-32.9
1982	85.5	106.6	-21.1
1983	74.9	110.5	-35.6
1984	76.9	129.9	-53.0
1985	73.4	125.8	-52.4

Source: U.S. Department of Commerce

Table 2. U.S. Trade Balances by Region, 1980-1985
(Billions of Current Dollars)

	1980	1981	1982	1983	1984	1985
World	-32.1	-39.7	-42.6	-69.4	-123.3	-148.5
Developing Countries	-38.8	-32.9	-21.1	-35.6	-53.0	-52.4
Latin America	.0	1.3	-6.0	-17.9	-20.4	-18.1
Asia	-14.5	-17.4	-7.1	-11.5	-26.4	-29.2
Africa	-24.5	-17.0	-8.3	-6.4	-6.2	-5.2
Europe	0.4	0.3	0.3	0.3	.0	.0

Note: Imports are c.i.f. values and Exports are f.a.s. values.
SOURCE: U.S. Department of Commerce, Highlights of U.S. Export and Import Trade.

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The U.S. trade deficit with developing countries is largely due to the burden of the debt and the weakness of world growth, especially in developing countries.

Of course, some of our partners have indeed contracted imports and promoted exports using barriers and subsidies. For the most part, these offenders are developing countries that are suffering from debt crisis. This trade policy action should be seen, in part, to be a result of the pressures to service the debt. In fact, the United States, through the IMF and banking policies, has supported this sort of trade policy in the Third World as a means for resolving debt problems. Thus, most of the U.S. trade deficit with the Third World is a result of debt, not unfair trading practices.

One major cause of the U.S. trade deficit is the pattern of the global recovery. In short, the United States has grown much faster than most other countries in the world. This has had a very predictable effect on the U.S. trade balance. With the U.S. market being the fastest growing one, the recovery of other countries' exports have been centered on selling to the American consumer. More importantly, the export imperative facing the debtor countries has forced them to exprt more than they import. Since the European industrial countries have been experiencing a slow recovery, they have not been able to buy as many of the Third World's goods as has the United States.

The effect of this difference in growth rates can be seen in world trade statistics. The U.S. share of world imports rose from 13.3% in

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1980 to 18.5% in 1984. Also, the U.S. share of the industrial-country imports has risen from 18.8% in 1980 to 26.0% in 1984. These trends also hold true for imports by industrial countries from developing countries. The U.S. share of industrial-country imports of all commodities from the Third World has risen from 32% to 40%. The U.S. share of industrial-country imports of Third World manufactures has risen from 38% to 53% for the same period. Yet, despite these increases in the American share of world imports, the share of imports as a percentage of U.S. GNP has not risen since 1980. In fact, U.S. imports of merchandise as a percent of GNP fell in the recession and bounced back in the recovery, but is still slightly below it 1980 level. Thus, it is incorrect to say that the United States has been experiencing an extraordinary import surge. The level of imports has been nothing more than should have been expected during a recovery.

Differences in growth rates around the world have had a more significant effect on U.S. exports. In 1980, U.S. merchandise exports accounted for 8.4% of GNP. By 1985, that figure had fallen to 5.3%. Even if one adds in the export of services, U.S. exports fell from 12.9% of GNP in 1980 to 9.3% of GNP in 1985.

Thus, the U.S. trade balance has suffered due to the economic problems in the Third World, which have damaged U.S. export opportunities, and due to the slow growth in other industrial countries, which has made the United States the major market for developing country exports. Of these two effects, the decrease in U.S. export opportunities has been more significant than the surge of imports into the United States.

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The differences in growth rates, however, do not fully explain the fall of U.S. exports. The Third World debt has been the other major factor. Since Third World growth rates on average rebounded to a higher rate in 1984-85 than did growth rates in European industrial countries, one should have expected that U.S. exports to the Third World would have increased at a faster rate than exports to Europe in 1984-85. However, this was not the case, due to the Third World debt. Despite the recovery experienced by the Third World in 1984-85, U.S. exports to developing countries did not recover as fast as U.S. exports to other countries. In 1984, U.S. exports to developing countries rose 2.6% from the 1983 level (a slight fall in constant dollar terms). Exports to the rest of the world rose 12.3% from 1983 to 1984. In 1985, U.S. exports to developing countries fell 4.5%, while exports to the rest of the world fell only 0.6%.

U.S. exports to the developing countries also declined more than other exports during the five year period 1980 to 1985. In that period, U.S. exports to the Third World fell 24.8% in real terms, while exports to the rest of the world fell by 11.7%. Even more to the point, U.S. exports to debt-strapped Latin America have fallen 30.6%. Further, U.S. exports to 21 developing countries heavily burdened with debt fell by 31.3% in real terms between 1980 and 1984.

Thus, trade and growth figures seem to confirm that the Third World debt has had a major impact on U.S. exports. This should not surprise us, since six major Latin American debtor countries have reduced total imports from the world by 33.5% during the 1980-1984 period. In the

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same period, imports from the world by developing countries with debt-service problems fell by 43% in real terms.

JOB LOSSES

The decline of U.S. exports to developing countries in the period 1980 to 1985 has had a significant impact upon employment in the United States. The first thing to be sacrificed by a country when it is forced to take austerity measures is spending on luxury items. The second is spending on heavy capital goods--especially the big ticket items such as aircraft, railroads, cars, trucks, construction machinery and machine-tools. These are the sectors of the U.S. economy which have suffered the most due to Third World recession and debt.

In 1985, the United States had 632,000 fewer jobs due to the decline of exports to the Third World since 1980. Additionally, about another 930,000 jobs have been lost which would have been created if the growth trend of the 1970s had continued after 1980. Thus, nearly 1.6 million U.S. jobs have been lost due to the recent recession in the Third World. This represents nearly 19 per cent of official U.S. unemployment in 1985.

Table 3. Export-Related Job Losses, 1980-1985
('000s)

World	-1114.9
Developing Countries	-631.7
Latin America	-359.0
Asia	-183.6
Africa	-81.4
W.Europe	-8.3

Data on the job losses through 1984 show that of the 560,000 jobs that did not exist in 1984 which existed in 1980, 500,000 were due to the

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fall of non-agricultural exports. Nearly 300,000 of those were due to the machine and transport equipment export decline.

The second major sector to suffer is that of manufactured goods classified by materials. About 125,000 jobs were lost from this sector due to the lost exports to developing countries in 1980-1984.

MANUFACTURING INDUSTRIES: THE SECTORAL COSTS, 1980-1984

The manufacturing sectors have been most damaged by the recession in the Third World. This section analyses the most significant manufacturing industries--classified as important either in terms of overall U.S. exports or in terms of developing-country share of U.S. exports by the industry. Out of the over 100 industries analysed, over 80 per cent suffered export declines from the 1980 level. Generally, aircraft, motor vehicles, transportation equipment, and power-generating equipment have suffered the most. The success stories are relatively limited--to industries related to electronic computers and office machines. Table 4 shows the ten industries with the largest losses in employment and the ten with the largest gains in employment.

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Table 4. Selected Export Sectors with Large Changes in Employment Due to the Change in Exports During 1980-1984

SITC #	CATEGORY	ESTIMATED CHANGE IN JOBS
7925	Airplanes	-69,300
7442	Lifting, loading and conveying machines	-23,500
7234	Construction and mining machinery, NSPF	-23,000
7843	Parts of road vehicles and tractors	-21,300
7821	Trucks (excluding truck tractors)	-19,900
7239	Parts of civil engin. and contractors plant equip.	-16,500
7810	Passenger motor vehicles (excluding public service)	-14,800
7223	Tractors, tracklaying type	-10,800
6911	Finished structural parts and structures iron and steel	-10,000
7224	Wheeled tractors (exc. road and industrial)	- 9,300
7599	Parts of auto. data processing and calculating office-machines	+21,000
7768	Piezo-electric crystals, mounted and parts	+20,600
7929	Parts, for aircraft and spacecraft	+13,100
7649	Parts of TV, radio and sound reprod. equip	+ 8,000
7764	Integrated circuits	+ 7,400
7526	Aux. storage units, terminals, etc. for auto. data processing	+ 4,200
7731	Insulated electrical conductors (cable)	+ 4,100
7523	Digital central processing units	+ 3,800
7522	Complete digital data processing machines	+ 2,800
7146	Aircraft jet and gas turbines	+ 2,600

Source: Author's calculations from U.S. Department of Commerce data.

Of the ten largest of these manufacturing export industries, measured by the value of their exports, only two showed increases in exports in real terms (see Table 5)--the two industries that supply parts for aircraft and for electronic tubes and semi-conductors. This is not surprising since, when forced into austerity, developing countries will reduce their buying of new machines while increasing their purchasing of parts to maintain their old machinery.

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Table 5. Performance of Ten Major Export Sectors, 1980-1984

SITC #	CATEGORY	EXPORTS ($ millions) 1980	EXPORTS ($ millions) 1984	REAL CHANGE IN EXPORTS 1980-1984 (%)
7925	Airplanes	3671	1,621	-62.3
7843	Parts for road vehicles and tractors	2440	2,032	-28.9
7768	Piezo-electric crystals, mounted and parts	2184	3,351	+31.1
7239	Parts of civil engin. and contractors plant equip.	2108	1,831	-25.8
7929	Parts, NSPF of aircrafts and spacecrafts	1307	2,036	+33.2
7442	Lifting, loading and conveying machines	1021	286	-76.1
7234	Construction and mining machinery, NSPF	1003	285	-75.7
7821	Trucks (excluding truck tractors)	903	287	-72.8
7139	Parts of piston-type engines (except air-craft)	823	844	-12.3
7721	Electric current carrying wiring and parts	767	892	- 0.6

Source: U.S. Department of Commerce.

While there have been tremendous jumps in U.S. exports of computer-related items, rapid increases have been limited to this sector. As shown in Table 6, which ranks industries by their percentage changes, many industries have suffered large declines, while only a few have registered significantly higher exports.

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Table 6. Large Changes in Exports of Selected Products, 1980-1984

SITC #	CATEGORY	REAL CHANGE IN EXPORTS 1980-1984 (%)
6725	Iron and steel blooms, billets, slabs, sheet bars and roughly forged pieces	- 97
7832	Road tractors	- 92
7938	Tugs, special purpose vessels; float structures	- 90
7147	Gas-turbines for mechanical drives and non-piston engines and turbines, NSPF	- 89
6252	Pneumatic tires for trucks and buses, new	- 84
6747	Tin plate and tin coated sheets and strips	- 83
7223	Tractors, tracklaying type	- 81
6353	Builders' woodwork and prefab buildings	- 79
7861	Trailers and intermodal transport containers	- 77
7442	Lifting, loading and conveying machines	- 76
7764	Integrated circuits	+184
6429	Articles of paper pulp, paper board, NSPF	+103
7599	Parts of auto. data processing and calculating office machines	+102
7523	Digital central processing units	+ 74
7731	Insulated electric conductors, cables	+ 72
7522	Complete digital data processing machines	+ 70
7146	Aircraft jet and gas turbines	+ 57
7649	Telecommunications equipment	+ 41
7526	Aux. storage units, terminals, etc. for auto. data processing	+ 34
7929	Parts, NSPF of aircrafts and spacecrafts	+ 33

Source: U.S. Department of Commerce data.

POLICY ALTERNATIVES

The debt crisis is having an adverse effect on the U.S. economy as a whole, not just on the banking sector. It is imperative that the U.S. government begin to move toward a policy of cutting the costs of the debt crisis. Through wise debt management policies, it may be possible to limit the extent of the damage to the global economy as well as to our own economy.

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Policy Alternative 1: More of the Same. This classical, orthodox approach to dealing with the debt crisis (through drastic import compression) has been in use for well over three years now. The result of this approach has been a continued significant risk for the international financial system, while severely damaging U.S. industry and employment, without reducing the present or future debt burdens weighing down the economies of the Third World. Meanwhile, the commercial banks have retrenched to the point that they are unwilling to commit new money to the region--thus, substantially darkening the future in a Third World with an oversupply of labor and undersupply of capital. Continuation of this strategy risks a collapse some of the Third World economies, defaults by important major debtor countries, global monetary contraction (due to bank failures), a deflationary depression of frightening magnitude, and sluggish world trade. The one consolation for some major commercial banks is that those that can weather the storm can look forward to a consolidation in the financial world, giving them a larger market share.

The folly of adhering to this policy was implicitly recognized by Treasury Secretary Baker last fall at the Joint Bank/Fund meeting in Seoul.

Policy Alternative 2: Baker Plan. The Baker initiative shows a significant shift in attitude on the part of the U.S. government toward the gravity of the crisis. The plan calls for renewed lending to the major debtor countries in an effort to reduce the net capital outflow from debtors that presently marks the debt crisis. While this will cer-

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tainly forestall a major collapse of the system for the time being, this strategy does not offer a light at the end of the tunnel. While nominally calling for growth in the Third World to alleviate the debt crisis, in fact the main emphasis is still on austerity and policy reform in the Third World. The amount of money that the World Bank can currently commit to the problem is insignificant compared to the net capital outflows. Furthermore, the plan proposes only a small increase in new commercial lending and, more importantly, shows little sign of materializing. Prudent bank practices direct wariness at creating new exposure in such risky financial circumstances. Thus, the Third World policy reform leg of the plan seems to be the only real instrument of the plan. The likely medium-term outcome of this policy is minimal changes in net capital flows, continued growth in the absolute size of the debt burden, and continuing austerity in developing countries.

In the end, this policy offers only a delay of the dangers inherent in Policy Alternative 1.

Policy Alternative 3: Debt Relief. The reduction of current and future debt service burdens is an option that implies losses for the banking community. In fact, as my earlier remarks convey, the U.S. economy as a whole is already losing because of the debt crisis. The choice facing the U.S. government is one of how to reduce the overall loss to the U.S. economy and how to distribute the impact of these losses fairly. Until the shift in attitude signified by the Baker plan, the U.S. government showed every sign of letting the banks and the developing countries decide these effects. Unfortunately, the Baker plan does not go far

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enough towards finding a way of burden-sharing that is both fair and likely to reduce the impact of the losses.

There are two reasons why the Baker plan holds very little hope for a redistribution and reduction of the costs of the debt crisis. First, the World Bank is intergovernmental, not independent of political pressures. It has not yet been designed to be the world's central banking authority. Significant changes--changes that have to be weighed against the potential for undermining the Bank's present positive development role--would have to be affected to make the Bank an effective debt mediator. Second, it is not in the interest of the commercial banks to seek a fair distribution of the costs of the debt crisis. Their concern quite naturally is for their own profits and exposure. Since they have most of the bargaining power in debt management discussions with developing countries, they are not likely to seek solutions that benefit the wider global economy. Thus, debt management carried out essentially through the commercial banks may not be in the interests of the wider U.S. economy.

Therefore, effective debt relief can only be carried out by active intervention by the U.S. and other industrial-country governments (assuming the Bretton Woods institutions are not radically altered). There has been a wide variety of debt relief measures suggested in recent years. Some of the most useful suggestions are summarized below (see "Restoring Confidense in International Credit Markets" by Richard Feinberg in Uncertain Future: Commercial Banks and the Third World for a more detailed analysis of these measures).

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DEBT RELIEF MEASURES

One idea is to place a "cap" on the annual interest payment burden of the debtor countries. The cutoff point can be tied to a variety of indicators. Several debtor countries have advocated tying payments to the level of export revenues. This would lend a certain predictability and stability to world trading markets as the debtors be more able to pay their import bills. The cutoff point can be tied to the level of interest rates--giving the debtors a discount. A two percentage point interest rate reduction would substantially relieve debt service problems, while not threatening the banking system with insolvency.

Of course, this does mean either forgiving or capitalizing that debt service burden that is above the cap level. A complementary idea is writing off the most value-impaired debt. Many banks already have sold some of their loans at discounted rates. The idea of not getting back every penny lent, is not new and is not necessarily a threat to financial stability. It makes no sense to continue to include these debts in new loan restructuring agreements. Their presence in the portfolio only serves to increase the refinancing fees charged--even though neither the banks nor the debtors believe the principal will ever be paid.

Such write-offs are made more difficult for U.S. commercial banks because of U.S. banking regulations. Other countries have given their banks more flexible write-down regulations which have softened the immediate effects on the profits of the banks. Thus, revised banking regulations can play a positive role in debt relief.

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Any comprehensive debt management scheme must wrestle with the issue of igniting new lending. Commercial banks are unlikely to sink in more funds after having to take losses. One way of keeping liquidity available to worthy Third World borrowers in the future is to establish a trust fund with the repayments of current debts. This fund would then be a source of new lending for profitable investments aimed at stimulating longer-term growth in developing countries.

As the banks may not be willing to adopt these approaches to the debt crisis, governments or multilateral institutions may have to buy the debt obligations from the banks in order to implement these strategies effectively.

DEBT RELIEF AND INTERNATIONAL TRADE POLICY

A more activist governmental approach to resolving the debt crisis should encompass the issue of appropriate, complementary trade policies in the United States, in other industrial countries, and in debtor countries. The tremendous, recent shift in the U.S. trade balance has been beneficial to debtor countries, in that our deficit is necessary to allow their trade surpluses, which in turn are necessary if debt service payments are to be met. However, the size of the U.S. trade deficit is unsustainable politically, if not economically. Just as the Third World economies cannot sustain the large drain of their export earnings to service their debts, the U.S. export sector should not continue to suffer from contracting markets.

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Of course, the United States has to run trade deficits with debtor countries if debt repayment is expected. Otherwise, there would be no way for the debtors to transfer real value to creditors. Thus, U.S. trade policy would be amiss to expect a rapid return to trade balance with debtor countries. Yet, current U.S. trade prospects not only hold out deficits in the immediate future, but trade is stagnant and declining in some industries. If the U.S. export sector is to revive, then total trade with debtor countries will have to increase. This is only possible in an expanding business climate. While parts of the Third World have undergone mild recovery in the last two years, growth prospects remain dampened by the austerity measures required by current debt strategies.

More than simply a matter of austerity, current debt policies have advocated trade liberalization in debtor countries. While trade liberalization policies in debtor countries seek to establish more efficient, export-oriented growth, the short-run impact of such policies is usually the reverse--a rapid rise in imports. This is temporarily good for U.S. exports, but potentially disruptive to debt service. For most developing countries, liberalization can only succeed if undertaken gradually. Even then, these countries will continue to experience difficulty importing due to debt service problems and slow growth. Further, liberalization may be politically discredited if it is tied to austerity measures. The militance of radicals within the debtor countries feeds on the structural dislocations caused by these liberalization measures.

Thus, extreme liberalization measures within debtor countries at this point in time politically and economically endanger debt management

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policies. Attempting to use World Bank lending to rapidly alter the trade policies of debtor countries may lead to ruin for debt management policy.

A more appropriate global trade strategy that is complementary with a solution to the debt crisis should seek the opposite--an expansion of the economies of the creditor nations. The U.S. market has been the major recipient of the Third World's exports in recent years. If this cannot be continued, then the burden of change should rest on other industrial countries. Europe and Japan need to pursue expansionary policies which lead to stronger import demand. Further, European and Japanese trade practises need to accomodate such a rise in import demand. If all three major industrial areas--the United States, Europe, and Japan--pursue open trade policies and sustained rapid growth, then the Third World will be able to significantly increase both its exports and it imports. Though the effect on the U.S. trade balance with developing countries may only be gradual, at least the expanding export markets abroad will help revive U.S. export industries and jobs.

CONCLUSION

Concern about the link between trade and debt issues in today's global economic environment is warranted. However, the cart must not be put in front of the horse. Financial considerations are the major barrier to U.S. trade with the Third World. Any attempt to rectify the U.S. trade deficit first will only exascerbate the debt crisis. Yet, providing debt relief will reduce the U.S. trade deficit and especially will help U.S.

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export industries. Debt management should be placed ahead of trade deficit reduction on the U.S. policy agenda with the Third World.

Furthermore, debt relief must come soon. U.S. export-related jobs are being lost. Import-competing industries are being pressed. Moreover, with each passing day, Third World leaders become less willing to follow the current approach to the debt crisis--and for good reasons.

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Chairman LUNDINE. Thank you.

Mr. Pierce, we were cautioned at the outset of these hearings—so what if you help the debt-ridden countries. Is it going to make any difference to business?

Maybe you can tell us about business.

STATEMENT OF J.B.L. PIERCE, TREASURER, THE BOEING CO.

Mr. PIERCE. Thank you, Mr. Chairman, and we will, indeed, point out how it will make a difference to business.

Boeing is heavily dependent on foreign markets for jet aircraft production. Over the last 10 years, about 60 percent of our deliveries have been to non-U.S. airlines. The Third World has been one of our fastest growing markets until the debt crisis in 1982.

As the import restrictions were imposed upon Third World countries, distortions began to emerge which began to impede the normal flow of trade and caused competitive export financing among exporter nations, such as subsidized credits, mixed credits, and tied aid financing.

In certain cases, Boeing has been able to preserve exports in the Third World by permitting these foreign airlines to use or to rent, if you will, aircraft through operating leasing structures. In essence, what we've done is gone off the country's balance sheet. We have done this in Morocco, Brazil, Chile, El Salvador, Mexico, and so forth. But leasing is costly and has only a partial impact on the trade balance problem.

As far as tools like counter-trade, in the form of barter or off-set agreements, some have promoted barter as the solution, when in truth, the track record of bartering has been less than impressive. It's inefficient.

Success stories have gained attention, such as Saudi Arabian oil for 747 aircraft, Algerian oil for Japanese autos, and so forth. But there is only a limited number of success stories and the track record is probably in truth, something like 1 out-of-50 for successes, for everything that is worked on.

The grim fact remains the poor nations of the world are becoming even poorer and less capable of repaying outstanding debt. The precipitous drop in commodity prices has caused loss of foreign exchange and the relatively slow economic growth of the industrialized nations of the world has been too small to pull the Third World out of its debt predicament.

During the 1982 debt crisis, it was estimated that a minimum real growth rate of 3 percent among the OECD nations was necessary to permit the Third World to overcome its debt, assuming that trade channels would remain open.

However, such overall growth has not occurred since 1982 among the OECD. We have had good years in 1984-85, but bad years in 1982-83, and 1986 remains a mystery. So rolling over old debt or rescheduling has prevailed.

There will be more trade disputes and continued credit wars if the OECD economic growth rate remains at or below 3 percent. In the meantime, the Asian and the Middle East markets now exhibit slower growth.

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The Third World, in order to repay its debt, must have export markets for its products.

Easing of U.S. trade protectionism may be only a temporary phenomenon, based on the expectation that a lower dollar will relieve friction between the United States and its trading partners. Other OECD nations have become even more export-dependent during the past few years, when the dollar was high; they have built up an industrial base oriented towards world market exports.

The number of complaints and filed investigations by the ITC in the last year have set a new record.

The Third World debt crisis should be viewed as an international security problem, not just an economic and financial problem. The debt crisis will become more and more politicized.

A permanent and stable solution is necessary. The Baker plan that has been proposed is a remedy. But this plan needs to be gauged carefully with regard to expectations. First—is the funding sufficient? Is it enough to do the job adequately and will it produce some debt relief immediately?

Some congressional support will also be necessary; namely, the near-term capital increase requirements of World Bank or World Bank affiliates. The Multilateral Investment Guarantee Agency, MIGA, proposed in Mr. Lundine's legislation, is an incentive necessary to encourage the return of private capital flows.

However, much is made of the flight of capital. Money goes where it is welcomed and stays only so long as it is well treated. And before the flight of capital reverses to these Third World countries, there has to be a stable program that invites the flown-away capital to return to the host country.

Raising the gearing ratio at the World Bank to two-to-one certainly deserves our support.

You have requested our views on how the Third World debt affects U.S. trade interest and jobs. I would like to address some ways in which Congress can assist all U.S. exporters.

First, we have proposed the enhancement of the Eximbank Financial Guarantee Program. That would draw in more additional sources of private capital, lower the costs to the buyers overseas, eliminate the need for subsidies, and contribute to reducing the Federal budget.

It's also imperative, however, that the Eximbank Direct Credit Program continue to be preserved in some form to assist Third World nations. This is because commercial banks will not provide a loan supported by an Exim guarantee if the expectation is likely that the guarantee will be called upon.

Furthermore, the banks are reluctant to rely upon the Exim guarantee if they expect the nation in question to undergo rescheduling downstream. It's not a question of country exposure; it's a question of country limit, with or without an Exim guarantee.

There are some new techniques for export financing, such as leasing, the use of asset-based value financing. And Exim has been helpful, indeed, in developing new leasing programs and also a Political Risk Insurance Program to protect against confiscation. And Exim should be congratulated for their efforts.

I would like to make several remarks about securitization because the ability and the opportunity to securitize outstanding

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Third World debt reducing the prevailing interest costs. More importantly, recasting these debts into longer maturities, is worth our focus.

One way to remove the Third World from the constant necessity of renegotiating short-term debt is to look in the area of securitization, openly recognizing the fact that such LDC debt cannot be repaid immediately at full face value.

Hence, to convert it into more manageable repayment periods, rather than continue the charade of rolling over debt again and again, constantly jolting the ministries of finance of these Third World countries, is attractive.

Stability is the most important factor that is required. A joint program development of securitization between the commercial banking industry and the international agencies, such as the World Bank, would give the LDC's the breathing room that they require.

It's interesting to note in Morgan Guaranty's February 8 newsletter, an acknowledgment that the 1981-85 debt management strategy which took the classical approach, namely, seeking to strengthen the export performance of LDC's and curtailing imports, essentially did not work. It became nothing more than a stop-gap measure.

In short, the classical approach is not applicable. Something of a more permanent nature is necessary.

In summary, Mr. Chairman, I endorse your proposals which call for accelerating the disbursement of the World Bank's capital, increasing in structural adjustment industry sector loans, plus the MIGA Program and increasing the gearing ratio of the World Bank on a 2-to-1 basis.

Thank you very much.

[The prepared statement of Mr. Pierce follows:]

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Statement of

J. B. L. Pierce
Treasurer–The Boeing Company

U.S. House of Representatives
Committee on Banking, Finance and Urban Affairs
Subcommittee on International Development
Institutions and Finance

"Developing Countries' Debt and U.S. Trade"
March 19, 1986

BOEING

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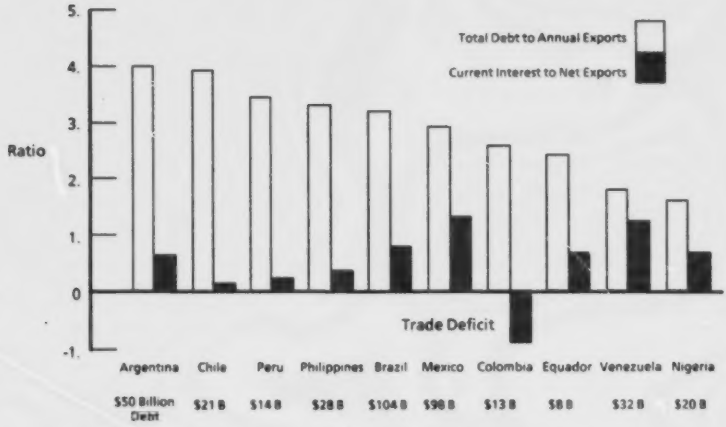
Thank you, Mr. Chairman. My name is Jack Pierce and I am Treasurer of The Boeing Company. I appreciate this opportunity to testify before your committee.

The Boeing Commercial Airplane Company is heavily dependent upon foreign markets for sales. Over the last 10 years, over 60% of our deliveries have been to non-U.S. airlines. Boeing is one of this nation's top five exporters. The Third World countries, until the 1982 Debt Crisis, was one of our fastest growing markets. However, today, some of these countries are so indebted that their export earning power won't even cover their existing debt service costs.

balance that suffers. As import restrictions are imposed, distortions begin to emerge which impede the normal flow of trade, such as export financing among exporter nations. The evolution of subsidized Mixed Credits and Tied-Aid financing are good examples. In certain cases, we have been able to preserve some business in the Third World by permiting the airlines to use – or rent – aircraft through operating leases. But leasing can be costly, and has little real impact on trade balance problems.

Tools like Countertrade in the form of barter... or offset agreements...are necessary. Some have promoted barter as one solution. In

MFigure 1
Major LDC Trade and Debt
1984



When Third World nations face adjustment programs which dictate restrictions on imports...and expansion of exports ... as the TOP domestic priority, it is the U.S. trade

truth, the track record of bartering is less than impressive. Barter is inefficient. Most is executed using "near cash" type goods...like oil and other commodities, which now, due to

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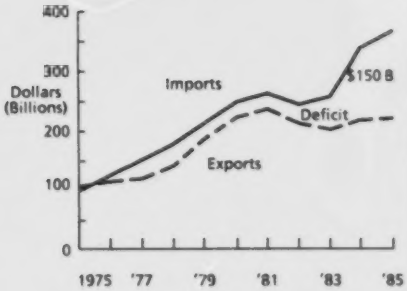
falling commodity prices, are creating substantial difficulty for bartering parties. Success stories have gained attention, e.g., Saudi oil for aircraft, Algerian oil for Japanese autos...Jamacian bauxite for trucks and cars and Ghanian diamonds, wood and rubber trades to Bulgaria for pharaceuticals and agricultural equipment. But, there are only a limited number of success stories here.

Figure 2
History of U.S. Trade Trends
Merchandise Trade in Billions



The grim fact remains...the poor nations of the world are becoming even poorer...less capable of repaying outstanding external debts. The precipitous drop in commodity prices has caused substantial loss of potential foreign exchange earnings. Also, economic growth in the industrialized nations of the world has been too slow to pull the Third World out of its debt predicament.

During the 1982 debt crisis, it was estimated that a minimum "real" growth rate of 3% in the O.E.C.D. nations was necessary to permit the Third World to overcome its debt...over a period of years...and assuming trade channels would remain open. However, such growth has not occurred since 1982 in the O.E.C.D countries. "Rolling over" old debt or re-scheduling has prevailed.

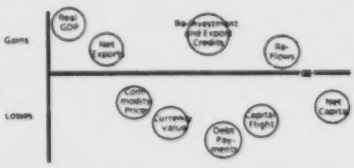
Table 1
Economic Growth in Industrialized Countries
(Percent Change in Real GNP)

Country	1960-69	1970-79	1980-85	1986 Forecast
U.S.	4.2	3.1	2.1	2.8
Japan	11.6	5.4	4.3	3.4
Germany	5.6	3.1	1.2	3.2
France	5.8	4.1	1.2	2.0
U.K.	3.1	2.4	1.1	2.5
Italy	6.3	3.3	1.4	2.0
Canada	5.2	4.3	1.9	3.0
Seven Countries	5.7	3.6	2.2	2.9

Source: Morgan Guaranty, December 1985

There will be more trade disputes...and continued credit wars... if O.E.C.D. economic growth remains at or below 3% per year. Asian and Middle East (OPEC) markets now exhibit slower growth. The Third World, in order to repay its debt, must have export markets for its products...open and capable of buying its products.

Figure 3
LDC Debt Growth Continues



Some easing of trade protectionism in the U.S. may only be a temporary phenomena, based on expectations that a lower dollar will relieve some friction between the U.S. and its trading partners. But, other O.E.C.D. nations have become even more export dependent these past few years, building an industrial base oriented toward world markets, mostly the

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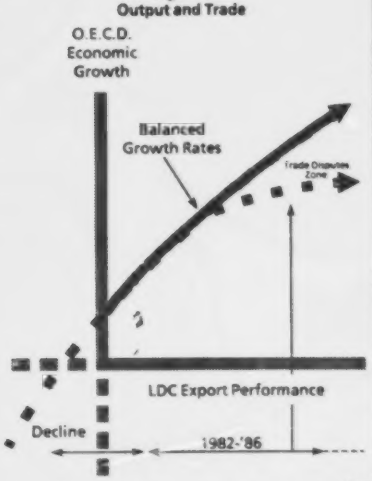
U.S. The number of complaints and investigations by the I.T.C. last year set a new record. More high tech industries are seeking relief.

Figure 4
Output and Trade



The Third World debt crisis should be viewed as a U.S. international security problem...not just an economic or financial one. If these nations cannot regain normal trading and economic growth, perhaps by limiting the amount of foreign exchange devoted to debt-servicing, then the debt crisis will become more politicized. The Cartagena Group has become more vocal and candid in proposing interest rate relief. They advocate a cap on the percent of their annual foreign exchange to be devoted to repayments. Some have suggested outright moratorium. They are becoming less willing to accept the political and economic cost of further IMF-like Adjustment programs.

A more permanant and stable solution is needed. Secretary Baker's Plan has been proposed as a remedy. This Plan needs to be gauged carefully, with regard to expectations. Is there enough funding suggested to do the job adequately? While much sound rationale has gone into the Baker Plan *vis-a-vis* the Long Term, will it produce some debt relief immediately? What other kinds of economic shocks that are inevitable will the plan accommodate?

Figure 5
Growth in O.E.C.D. Imports From LDCs

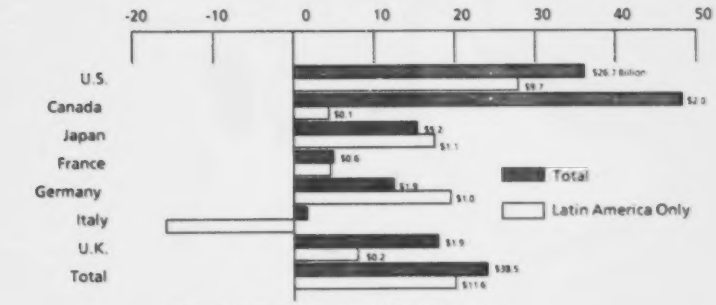


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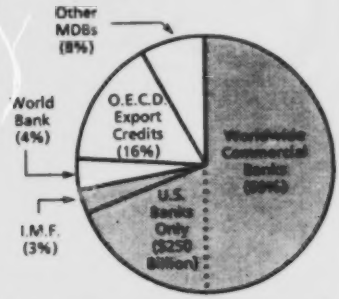
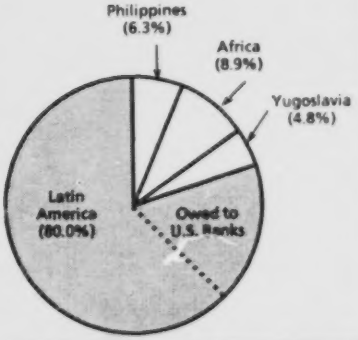
Figure 6
Owners of $920 Billion Third World Debt
(Year End 1985)



The enormity of the problem is concentrated in the Latin American nations. Ten of the 15 nations included in the Baker Plan lie south of our border. Of the $437 billion Baker 15 debt, $350 billion is Latin American indebtedness, and of that, 87% is owed by only five.

Figure 7
Baker's Top 15 Indebted Nations
(1985 Principal Only)



Some Congressional support must be forthcoming. Congress must face the near term capital increase requirements of The World Bank. The potential leverage is impressive: 60 to 1. The Multilateral Investment Guarantee Agency proposed in Mr. Lundine's legislation is an incentive necessary to encourage a return of private capital flows in both debt and equity participation. Raising the "gearing ratio" of The World Bank to 2 to 1 deserves in-depth examination.

Figure 8
Top Five Latin Debtors: 87% of $350 Billion
(1985 Principal – 1986 Interest Due)

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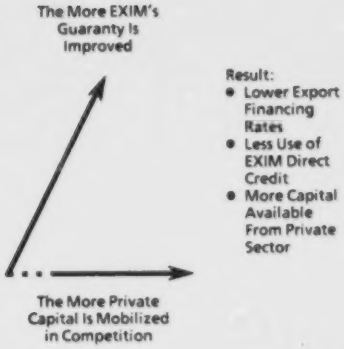
You have requested our views on how the Third World debt crisis may affect U.S. trade interests...and the jobs dependent on these markets. America's commercial jetliner industry will see the non-U.S. market continue to dominate our marketing efforts. The LDC nations represent a substantial market. I would like to address some ways in which Congress can assist all U.S. exporters, especially the capital goods sector which, for the first time in decades, face a trade deficit in 1986.

Figure 9
Enhanced Eximbank Guaranty


The More EXIM's Guaranty Is Improved
Result:
• Lower Export Financing Rates
• Less Use of EXIM Direct Credit
• More Capital Available From Private Sector
The More Private Capital Is Mobilized in Competition

First, exporters are seeking an Enhanced Financial Guaranty from the Eximbank. We believe it will be a very inexpensive and effective means to draw more sources of private capital into the export financing arena, lower the costs to buyers and exporters, eliminate the need for subsidies, contribute to reducing the Federal Budget and address some of the Third World capital goods requirements.

EXIM Direct Credit Program

It is also imperative that the Eximbank Direct Credit program continue to support U.S. exporters selling to Third World nations.

Although the EXIM Guaranty represents the full faith and credit of the U.S. Government, banks will not provide a loan supported by such a guaranty if the expectation is likely that the guaranty will be called upon. Furthermore, banks are reluctant to rely upon the EXIM guaranty if they expect the nation in question will undergo re-scheduling downstream. Country limits inhibit the banks' participation as well, even with a guaranty. It is for this reason...special debtor country situations...that the Direct Credit program at Eximbank continue. Unless there is a special program to assist U.S. exporters with direct credits to foreign buyers in Third World countries, it is likely that we will lose exports, and jobs related to these markets....and to foreign competition, who are willing to provide the needed credits.

New Techniques of Export Financing ...
...Using Asset-Based Financing

For certain products, which can be leased, (aircraft, for example) new programs are emerging which use the asset value of the product as a basis for export financing. The primary security to support the financing is the very product itself. In these cases, the aircraft is leased to the airline, with the expressed understanding that title does not pass. In essence, the aircraft is rented.

Exim has been helpful in developing new leasing programs to support these kinds of transactions. EXIM has developed a new political-risk insurance program which protects against "confiscation," so that even in cases of default, the aircraft can be repossessed and EXIM will cover the major portion of the non-repossessive risks.

These transactions – asset-based – permit aircraft, for example, to be exported into Third World nations to be used by the airlines in the form of a lease or rental agreement. By avoiding purchase, no debt is incurred...on

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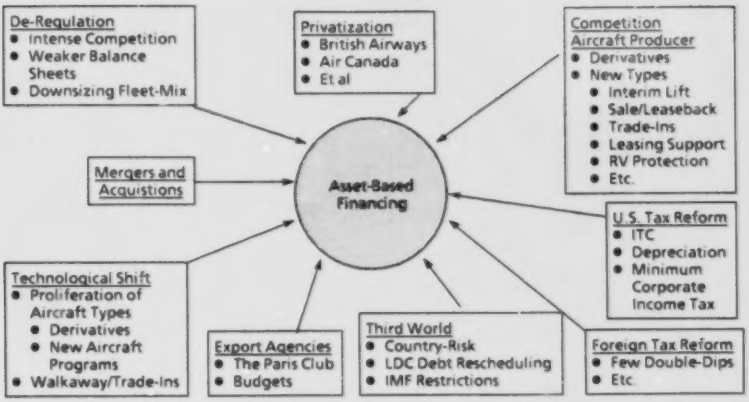
Figure 10
Asset-Based Financing



either the airline or the country's balance sheet. Thus, the LDC, even with restrictions imposed by their Ministry of Finance, can have what they need....and avoid adding to their debt or re-scheduling problems.

...Securitization

The ability and opportunity to securitize outstanding Third World debt, and reduce the prevailing interest costs, while recasting these debts into longer maturities...is worth our focus. It is clear that much of the debt is be kept "on the books" at face value, yet if securitized, with longer maturities, some discount features would be necessary. But it would be one way to remove from the Third World the constant necessity to renegotiate short term debt. What is the real difference between openly recognizing the fact that such LDC debt cannot be immediately repaid at full face value...and converting it into more manageable repayment periods...rather than continue to charade of "rolling over" debt, constantly jolting the Ministries of Finance in these LDCs?

Stability is most important...then follows more efficient planning and normal trade relations. A joint program developed around securitization concept between the commercial banking industry and international agencies, such as the World Bank, could give the LDCs some "breathing" room, and rebuild the reserves of the banks.

It is interesting to note that Morgan-Guaranty's February 8th newsletter acknowledged that the 1981-85 debt management strategy took the classical approach ..seeking to strengthen export performance of LDCs and curtailing imports. The article noted that previous experience with the classicial prescription in Europe and in some Latin American countries suggested that trade performance should be sufficiently improved after two or three years to restore normal credit flows, promote repatriation of flown-away capital and allow resumption of sound economic policy. However, the last three years proved this approach to be less than adequately responsive to the changing needs...nothing more than a "stop-gap" one.

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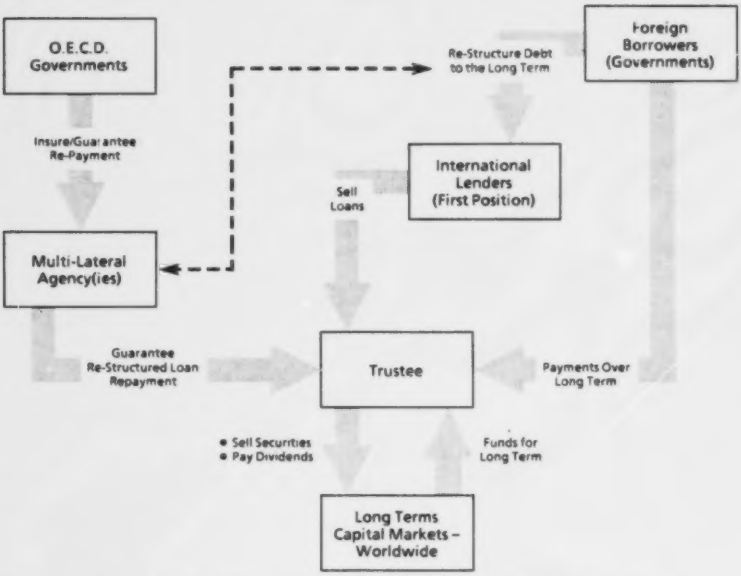
Figure 11
Securitization Concept for Third World Nations



In short, the classical approach is not working. Something of a more permanent nature is necessary.

In summary, Mr. Chairman, I endorse your proposals which call for accelerating the disbursement of the World Bank's capital, increases in structural adjustment and industry sector oriented lending, plus the MIGA and the increased "gearing" ratio of up to 2 to 1. I won't comment on changes in banking regulatory guidelines. This is just not my forte. I would encourage you to pursue attempts to securitize country debts, creating some mutually funded agency to act as trustee and oversee the flow-through of cash and guaranties required.

Before I conclude my testimony, I would offer one further idea. Trade distortions, due to export financing competition among government credit agencies have diminished in recent years, thanks to efforts of the Eximbank and the Treasury Department. However, there is a need today to begin addressing a rising source of friction and frustration; otherwise the playing fields of international competition will again be tilted against U.S. interests.

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A Master Guarantor program at the World Bank, or an affiliate, is needed to insure equality of opportunity for all participants in the growing internationalization of "big ticket' capital goods production, large-scale construction, engineering and power generating projects. More and more, these kinds of projects contain multi-national "shared-production" content. No single national credit agency will, or should, provide all the financial support necessary; but inevitably, they will compete over financing their national portions of the export. The U.S. should take the initiative to head-off this activity before it gets worse.

For example, in competition between U.S. and Airbus producers, various components of each aircraft are produced in different countries. Airbus produces its jetliners from parts made in France, Germany, England, Spain and the United States. Our 767 is produced in the U.S., Canada, Italy and Japan. It would equalize competitive pressures if all of the export credit agencies of these countries extended only pure cover...their guaranty...and the private capital markets could provide the export financing funds. However, today each country's guaranty is not treated equally in the world's capital markets. For example, an EXIM guaranty in the United States is better received than a COFACE...or HERME...or ECGD guaranty. Certain capital sources, such as insurance companies and pension funds, cannot provide funding using a foreign agency guaranty, beyond a total of 1% of its total portfolio. This portfolio-based rule excludes Airbus from U.S. capital markets, and they can be quite imaginative in finding alternates.

The answer to this potentially troublesome trade activity is for the various export credit agencies to extend their guaranty to the World Bank, which would then provide its guaranty..."pure cover"...to all participants equally. This "umbrella" guaranty, or service as a Master Guarantor, would bring more private capital to the market, lower costs/rates and greater trade among all nations.

Thank you, Mr. Chairman.

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Chairman LUNDINE. Thank you. And thank you all.

Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman. Thanks to our panel for their excellent testimony. I think it's all been quite helpful.

I have two questions. At least Mr. Tucker and Mr. Wolff brought up the suggestion of asking Japan and Western Europe, the OECD countries, to reduce the pressure on the U.S. market by taking more Third World exports. We all know the difficulty we have had with Japan in this instance and now there are clear indications, substantial evidence, that Western Europe is becoming more protectionistic.

Why should we look with an encouraging eye toward this solution, or this effort, at a partial solution?

I will ask Mr. Tucker or Mr. Wolff to respond specifically, and either of the other two panelists are free to if they care to.

Mr. WOLFF. The problem that is characterized primarily now as the United States-Japan trade problem is really a global trade problem.

We are importing too much and have our domestic accounts out of balance. The Japanese have too high a savings rate and don't import enough. It's a global trading system; it's not a bilateral problem. We each have a global problem.

If the Japanese took more textiles from Malaysia and Indonesia, more consumer electronics from Taiwan and Korea, they'd be taking pressure off of us.

Mr. BEREUTER. I understand the advantage. But why should we think they'll do that? They haven't shown any signs of doing it.

Mr. WOLFF. For one thing, we have never even asked them to. We have never really approached the problem as a global problem. We have not said that the international economic system is really one system that, as a condition of our underwriting of the International Monetary Fund, of the World Bank, of the other development institutions, as a condition of our continuing to underwrite the GATT system, we want greater burden sharing.

That just simply hasn't been addressed and it has to be. We still have some leverage in this world. I think that other countries tend to listen to what we have to say, if we speak in a united fashion and firmly enough.

Mr. BEREUTER. Well, if they haven't been asked, that's a terrible indictment of the executive branch of both of the recent administrations, this and the previous administration.

Mr. Tucker, why should we be encouraged that they will take these steps?

Mr. TUCKER. I think part of the problem is that it's very difficult to ask another country to do this. Macroeconomic policy is one of the areas where there is very little coordination between nations. We have only seen a rise of that sentiment for coordination with the Rockefeller Plaza declaration in September. And in that sense, this is a slow process and it will take time.

But I do think that the gravity of the crisis has begun to sink in for both Japan and Germany, which is one of the major leaders in policy in Europe, because they are beginning to see the United States economy slow down. And when that happens, no longer is there that tremendous import demand that we had of goods from

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the Third World, and those Third World countries are going to start looking toward their markets. When they can't find them, the debt crisis will become worse.

Any real understanding of the difficulties these countries are having with debt should produce a change in their policies. I do think there is also room for bargaining. We have ongoing discussions in Geneva over the multilateral trade negotiations. We have a seven-nation summit coming up which will be in Tokyo.

These are excellent opportunities for the administration to finally hammer home the point that they need to expand, they need to open up their markets. And it is too late for them to defer it further years.

But I do share some of your skepticism. They aren't as willing as we seem to have been in the past to accept these imports.

Mr. BEREUTER. The European community is producing sugar at unprecedented levels. I would be happy if they would simply stop devastating the nations of the Caribbean and Central America with their overproduction and their dumping of sugar.

They do more damage than all of their foreign assistance to that part of the world can possibly match, just by their production policies on one basis commodity in these one- and two-export nations of the Caribbean.

Dr. Stern, on page 12, you mention the accord that has been entered into with Mexico since they are not a member of GATT, and I find it interesting that their interest in becoming a member of GATT is finally peaking.

That accord, according to your statement, would permit subsidized Mexican imports to be subject to the injury test, a privilege they have not held to this point because they're not a member of GATT, in exchange for phasing out a variety of export subsidies.

Which is the initiating entity on the United States side for that accord?

Dr. STERN. It's very much in the hands of the executive branch. The ITC does not get involved in those negotiations at all. So that would be your President's Trade Representative.

Mr. BEREUTER. And, if you know, what authority do they cite for entering such an accord?

Dr. STERN. I cannot give you that, but I can certainly go back and try to track that down for you. I would be happy to.

Mr. BEREUTER. I would be interested since they have no powers that we don't give them in international trade. And I am just wondering if they have adequate authority to enter such an accord.

Dr. STERN. I think the former general counsel and then Ambassador Alan Wolff can probably answer that question. But if I might just pick up on your last question about encouraging our trading partners to take up much of the burden, or some of the burden that we have been shouldering in importing the goods from debt-ridden nations.

I think that the one point that was not mentioned which I would like to add is the fact that we have this windfall worldwide from the drop in oil prices which will be appreciated even more in Japan and in the European countries than it will be in this country, Japan, of course, being a major importer.

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You, as a result, will see, I think, a great deal more stimulation and room for growth in those economies. In Europe, for example, they have been strapped not only by the high cost of oil, but the fact that oil was denominated in dollars. And as a result, I think that there will be a lot more room for consumption.

As you know, we were the ones who really were the locomotives in a purely consumption-led recovery that left Europe in particular behind. And I would hope that now with the drop in oil prices, we will see a much more favorable environment to pick up on some of that consumption.

Mr. BEREUTER. Thank you for your comments. I guess just a gratuitous remark in closing.

I am not sure that entering an accord with Mexico in this instance is a good idea. Mexico does not participate in almost any national organization or agreement, including international transit standards and treaties.

I think it might be a good idea to have put the pressure on Mexico to bring them into GATT. I certainly hope that this effort does not deter them from moving into GATT. Why confer the advantages of GATT, the injury test, for example, unless they are willing to become a signatory to the general agreement on tariffs and trade.

Mr. Wolff, since you have had experience in that area, perhaps you would like to comment. And thank you for the time, Mr. Chairman.

Mr. WOLFF. Yes; I would agree entirely with your comments.

The authority is contained in the Trade Agreements Act of 1979. My understanding is that the Mexican Government has agreed to become a member of the GATT and subject itself to the GATT's rules.

There were assurances given to the Congress at the time of the passage of the 1979 act that with any developing country there would be a prompt phase-out, elimination, of export subsidies if the injury test was given to those countries.

It's not in the law, but it was a commitment given by the administration.

I have not seen the terms and conditions of the accession of Mexico to the subsidies code, but that's the standard to which they should be held.

Mr. BEREUTER. Thank you.

Mr. PIERCE. Mr. Chairman, I would like to clarify one point on the Japanese financial markets because it might be unfair to let it go without comment.

The Japanese do not produce commercial jet transports at this time, but they probably have been one of the most aggressive financing sources we have used. Up to 20 to 30 percent of all commercial jet transport exports in the last 2 or 3 years are the Japanese leasing companies. They have been in Brazil. They are in Morocco, all over the world, either using yen-based financing or reverse swaps into dollars. They have been there in support of U.S. commercial jet transport exports.

So whatever shortcomings are perceived elsewhere, they are indeed aggressive. I think that U.S. exporters simply have to know how to use the market, that's all.

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Chairman LUNDINE. In that kind of an arrangement, do they take the risk of repayment or do you?

Mr. PIERCE. Yes, sir, they do, indeed.

Chairman LUNDINE. Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

I would like to add my appreciation to those already expressed by my colleagues for the panel. It's been very instructive.

Not too much has been said by two of the points of the Baker plan that the Secretary feels are important. Foreign investment, in order to get that infusion of additional capital, and then the privatization of many of the industries of various countries that have an internal drain, capital drain, on the budget process.

I wonder if any of you would have any comments on those as to steps as far as trying to correct the basis upon which, then, purchases could be increased. And then I would conclude by specifically asking Mr. Pierce, is there a 7J7-type of arrangement possible with, say, Brazil or some other Latin American country that has airframe capability, where both parties would prosper or profit because it would create a more competitive international product? You wish to proceed, Mr. Pierce.

Mr. PIERCE. Yes; first, we have not completed the total survey worldwide of sourcing on supply or subcontract or associate contractor components. In fact, we have examined the capabilities of the Brazilian industry and continue to do so. As you know, they do have capability in aerospace through Embrear, their local company.

We have always said it's quality control, price, and scheduling that is paramount. That is what we look for in bids on the programs. And, worldwide everybody can bid. They are among several countries in the Third World to participate in international aircraft production consortiums.

We will continue to look at them for these reasons. Also, Brazil is one of our major export customers—VARIG Airlines, TransBrazil, and VASP.

On the question of enhancing private capital into the flows back into the Third World, I think the MIGA Program is a good step forward to encourage the flow of that capital to return.

As I've said, when you look at the adjustment programs that the IMF has imposed and if you transfer them over to the World Bank, calling them policy loans or whatever—unless those programs have a longer duration of permanency, that is, less renegotiation every year, as under the IMF adjustment program, it's hard to see private capital returning into these Third World countries because there's no stability in the program.

There's always unanswered questions. For example, are they going to impose exchange controls? What are they going to do in response to whose challenge?

Money goes where it's welcomed and stays so long as it's well treated. And if it doesn't see that it's going to be treated well, it's not going to return home.

On the issue of privatization, someone pointed out that if Mexico took all of their listed state-owned enterprises and sold them, they would be worth about $1½ billion. But the most important thing, as far as I am concerned, is taking that LDC debt and getting it

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recast out there into a longer term period, rather than pushing these rollover operations against them every year, year after year.

Mr. McCandless. Well, let me pose this as kind of a devil's advocate.

If we have this problem, and I understand and accept your answer about foreign investment, what is the inducement for Ford to go into Ermocia with a large truck plant, General Motors to go into Chihuahua with a small truck plant, car plant, in a volatile economy such as Mexico is experiencing? If there is something there that is attractive to those supposedly knowledgeable companies, isn't there something similar for another country in a similar situation?

Mr. Pierce. Individual capital has been leaving, and it's estimated that some $50 billion from Latin America could return and participate in some of these ventures, that a Ford or GM does. These are multinational corporations, probably with OPIC insurance against appropriation, or currency inconvertibility. These major projects in a world market, in a multinationalized setting, take the long view.

But when we talk of the flight of capital, we're talking about a host of small individual entrepreneurial capitalists who are just trying to hang in there and preserve the value of their money for now, then return when conditions stabilize.

It is one thing to speak of Ford or Boeing or General Motors. It is another thing to speak of somebody whose entire fortune is at stake.

So, I think, they will come back when the stabilization takes place.

Mr. McCandless. Mr. Wolff, you had a comment?

Mr. Wolff. Yes; one of the key elements of Ambassador Yeuter's program for the new round of trade negotiations is investment. It is an element that is most resisted by the developing countries and it's unlikely that we have the leverage in just the GATT in the current trade talks to bring investment within that framework, absent tying it to our activities with respect to international debt and the stabilization operations of the International Monetary Fund.

The leverage is in the other institutions. The draft bill that is before the committee today would allow the trade negotiators to address the distortions of the investment climate and the deteriorating investment climate that the developing countries are resisting today.

Mr. Tucker. If I might say something. The Overseas Development Council conducted a conference in October on this very question of direct foreign investment and its potential to replace commercial lending in the present environment. We have a book in the editing stages right now on that topic.

I won't be comprehensive in summarizing those reflections, but it was the general consensus among the authors, as well as the participants at that conference, that foreign investment certainly can be made a more positive element in the development problems of these countries, but it is a relatively small element compared to the debt crisis as it is today. And so, that is one element of size that we have to worry about.

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The other side of it is that foreign investment is going to run away from these countries the same way the banks are shying away. These countries do not look creditworthy. If you look at rates of returns on direct foreign investment in Latin America, they have dropped as much as 80 percent in some industries over the last several years and this is just unacceptable to a foreign entrepreneur.

Regarding some of the companies that have moved into Mexico, it's clear that some of the benefits they see of going in there is that they are going into a protected market. If they can bargain with the government for continued protection and get their investment inside, they are getting one up on their international competitors and that's part of the package for which they are looking.

Again, as Mr. Pierce has mentioned, smaller companies can't bargain for that.

Mr. McCANDLESS. Again, thank you.

Thank you, Mr. Chairman.

Chairman LUNDINE. Yesterday, we had a witness from Citibank who I could casually characterize as saying that we didn't have any problem. Actually, what he said, to be fair, is that we're halfway through the problem and that you don't expect these countries to pay off their debts. Just like the national debt, as long as they can service the interest and we're getting along fine, there's no real severe difficulty.

I gather from what particularly Mr. Pierce and Mr. Tucker said, you wouldn't agree with that. You would maybe argue, in Mr. Tucker's case, that the traded goods sector has suffered most of the loss while maybe the banking sector has not. And from the several intriguing ideas that Mr. Pierce offered, I gather you think there doesn't need to be some kind of restructuring.

Am I interpreting you correctly?

Mr. PIERCE. Yes. Frankly, I think the previous approach has been to work it on what is characterized as a case-by-case basis and every year, an ad hoc approach.

As I mentioned, in the Morgan Guaranty newsletter in February, this is the old method of approaching structural problems, suppressing imports, and promoting exports. But it has not worked, for the purpose of paying outstanding debt.

This is like an individual who holds a mortgage that takes anywhere from 40 to 60 percent of his net take-home pay. He is witnessing most of his foreign exchange, being dedicated to the repayment of previous outstanding debt with no opportunity to engage in normal trade operations, like the import of goods and services from the United States or the rest of the world or exportation. Suddenly he starts running into protectionism in some of the OECD countries, shutting off their markets to protect their domestic industries.

The Cartagena group has made it clear in one of their most recent meetings, either there is going to be a cap, like a certain percentage of annual foreign exchange earnings will be allocated to repay that debt, or there is going to be a moratorium.

Unless some of that debt is recast into a much longer term period, a long period of time before it is repaid, or a way is found of

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capitalization, or partial capitalization, there is no light at the end of the tunnel as someone has suggested.

That's why I've suggested looking into securitization, which has been used by ECGD in England on Third World debt, S.A.C.E., the Italian export agency has used it. Morgan Grenfeld did both transactions. More recently there's been some securitization of E.D.C. of Canada loans, by Morgan Stanley.

What I am suggesting is that the tight, short fuse which was supposed to be the way debt holders negotiate and force the indebted nations to repay, keeping their feet to the fire, is creating a very unstable situation in many of these countries. It's becoming more of an international security problem than it is an international economic problem.

Chairman LUNDINE. Mr. Tucker, did you want to comment?

Mr. TUCKER. Yes. I think your characterization is correct. If you look at the way debt management is conducted today, what happens is several hundred banks and the IMF sit down and talk with a country's government. That leaves zero leverage to the U.S. export sector.

Much of the U.S. economy is not involved in how you divvy up Mexico's export earnings, for example. What has happened is that they have been squeezed very tightly and the side that has suffered has been our exports to the debtor countries.

Chairman LUNDINE. If the World Bank were the catalyst to make that restructuring happen, would the U.S. export interest be given greater consideration?

Mr. TUCKER. Not specifically. But in a general sense, yes. I think the World Bank has a more global perspective on the economy than the debtor negotiation groups in the IMF, which especially have a short-term perspective.

The real question is whether the World Bank has the capacity to conduct such oversight of the negotiating process, and currently, I am not sure it does. There would have to be significant changes.

Chairman LUNDINE. What are those changes, just some of them. You said that during your testimony.

Mr. TUCKER. I am afraid I have led myself into an area in which I am not an expert. [Laughter.]

The World Bank is an organization that I don't have much knowledge of, so I am afraid I couldn't really tell you. I think people who could tell you are those who are knowledgeable about central banking activities. Chairman Volcker would certainly know what it takes to be an independent organization mediating between a variety of interests. And those are the people who should be answering that question.

Mr. PIERCE. I think the one key point is that giving the World Bank the assignment, instead of the IMF, simply switching hats over to the World Bank, means they are going to become the bad guys just as much as the IMF is to the Cartagena group.

Chairman LUNDINE. I don't want to sound defensive of my friend, Secretary Baker, but his idea, though, to be fair, is that we're not only going to shift some responsibility, but that we're going to emphasize growth rather than austerity. And basically, that is what you are saying. You may differ in the means to it, but you would support the idea that there has to be policy reforms in the develop-

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ing countries. There has to be some relaxation of the terms to allow them to experience some growth.

Right?

Mr. PIERCE. Absolutely! In fact, I would say the Baker plan, perhaps moves with the most recent problems of falling prices of oil and other commodities, if anything, needs further impetus. And while I certainly endorse the Baker plan as a move to solve the problem, the first word is stability before we can get to growth, away from the problem of the debt rollovers.

Year after year, renegotiation means constant feet to the fire. Ultimately, the LDC nations formed their own debtor group, the Cartagena Group, and have begun to negotiate as a group, saying: We just can't get back up on our feet in 360 days. It's going to take a little bit longer than that.

Chairman LUNDINE. Well, you don't need to respond, but I don't like to call it the Baker plan. I have exorcised that from this subcommittee because I don't think it's really a plan, in my view of what a plan is. It's an initiative that I welcome. But I do think that we've got to begin to bring it into sharper focus.

Mr. Wolff.

Mr. WOLFF. What you quote as the view of the Citibank representative is disquieting, although not surprising. It depends a lot on what the United States regards as its national interest with respect to the debt problem. And debt collection is certainly one aspect of the national interest, but that's not where it stops, obviously, as your bill indicates and as your series of hearings indicates.

Our interests also include growth in the developing countries, growth for our export markets. There are political ramifications in terms of our foreign policy interests. The parallels are striking between the handling of debt after World War I and World War II, and what we are doing today. We are just ever so much closer to what we did after World War I. Today we are focusing on debt collection, not on world economic growth.

Chairman LUNDINE. Well, you made a suggestion that when the IMF, and to the extent they will now, the World Bank, do annual reviews of countries, that GATT participate in that, as I understood it, so that there be a review of relatively how open are these countries to trade.

Would you make that a suggestion, even where the countries are not part of GATT?

Mr. WOLFF. I think one might have to, for diplomatic reasons, use GATT experts in an independent capacity where a country was not a GATT member.

Chairman LUNDINE. In other words——

Mr. WOLFF. There is a need for trade expertise. Whether one looks at Brazilian, Korean or Mexican informatics policies, Mexico not being a GATT member, the other two being GATT members, the distortion of world trade is the same. The expertise that is required to deal with that distortion is the same, and there should be personnel who are dedicated to removing those distortions who are made a part of the process.

Chairman LUNDINE. What you are really saying is if the World Bank takes on this increased catalytic role, at least, presumably

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envisioned by the Baker initiative, they ought to get that kind of trade expertise and we ought to be insisting that reasonable openness in terms of trade be a condition for any debt relief that is given.

Would that be a fair statement?

Mr. WOLFF. Exactly. Some of the key, most advanced developing countries also happen to be some of the most protectionist countries on Earth.

Now they have little scope for maneuver if they also happen to be the greatest debtor countries. But the United States scope for maneuver is narrowing, too, as we become one of the world's largest debtor countries.

So I think that if we can be lectured about openness, a healthy dose of that can be given to the developing countries as well.

Chairman LUNDINE. I never thought of it until right now, but when we become the largest debtor country in the world, we can use that as an excuse for protectionism. [Laughter.]

I am being facetious, I want to say for the record.

Mr. TUCKER. Can I comment?

Chairman LUNDINE. Yes, please do.

Mr. TUCKER. On this conditionality thing. I agree that we have a significant problem in entering the markets of some of the major debtor countries. Not all of these barriers are, indeed, thrown up for debt service reasons. They are, in some senses, unjustifiable under GATT rules. But the real question is the phasing of it.

If we are to solve this crisis, we need to be gradual on our approach on the trade side and quick on our approach on debt.

Dr. STERN. If I may just pick up your invitation on talking about Brazil.

Chairman LUNDINE. Please do.

Dr. STERN. I think that the point that Alan has made about what is our national interest and how we define it is critical. Right now, we see a great deal of emphasis on the part of our negotiators talking with Brazil about who will be able to invest in Brazil for the purpose of informatics, the informatics market.

At the same time, you have constant and continual and very important concern about how will Brazil repay its debt. The question of Brazil's long-standing mercantilist policies of import substitution which have been reinforced by the fact that they are also debtors now, and what that means for shrinking prospects for American products to be shipped from the shores of the United States down to Brazil I think has really been shelved.

The question is what is our national interest? I think it's a combination of all of those things, plus diplomatic concerns as well.

But I don't see, quite frankly, that the emphasis—I believe that the interest of United States industries in the United States has really not played a very important part in negotiations with Brazil.

The question always gets turned the other way, when United States interests in the United States producers are hurt by exports of Brazilian goods to the United States. But I simply feel that when looking at our bilateral relations, all of these things have to be taken into account.

I think that the definition of "national interest" has not really lined up very well.

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Chairman LUNDINE. Do you have any suggestion as to how you do that? Clearly, what's going on, not only our conversation prior to today, but many others, indicate to me that Brazil, to be specific, is using the debt servicing as an excuse for things that they want to do in any case to protect their domestic markets and to target development and to exclude the United States from participation in that market.

And I think, clearly, it's affecting U.S. industry, both from the export opportunity and the import penetration aspect. Now, undoubtedly, the issue ought to be raised. But my question is sort of by whom?

Dr. STERN. Well, to underscore your point, your description of Brazil, I think if you look at the study that we did that we published last year in the chapter we have on Brazil, it really is a house of horrors from the point of view of a person who believes that markets should be open and opportunities should be there for those to trade.

The answer specifically to your question goes back to our President's negotiator, the Trade Representative's office. That is where, it seems to me, you should be seeing a weaving together of all of these considerations.

Again, I leave that to others, with previous experience in the executive branch as to how that has been done in the past.

Chairman LUNDINE. Well, I wanted you to say that, not me, because they are coming in tomorrow. [Laughter.]

Two of the really interesting things that have been said here today is that Mr. Wolff has indicated that, in his judgment, we have never really asked Japan to take more developing country imports, import more into Japan. And you are indicating that you don't think, based on your knowledge and your extensive study, that it's been on the agenda to really negotiate with, for example, Brazil about this issue in conjunction with the debt issue.

And I will be sure to ask that tomorrow.

Mr. WOLFF. Just to avoid an easy out for your witnesses tomorrow——

Chairman LUNDINE. Good.

Mr. WOLFF. There has been some comment on Japan taking more of other countries' imports as well. But if you asked whether President Reagan at his meeting with Prime Minister Nakasone upcoming in mid-April is going to discuss the opening of the Japanese market to the goods of the world, and principally, the goods of the developing countries, as well as the United States, the administration would have to say, that's not one of the first several items, nor is it probably going to be raised at all by the President in these talks.

It is not an American priority.

Chairman LUNDINE. Well, I think that's a very important point because several months ago, prior to September, I met with some representatives of the Japanese Diet. They were clearly concerned about the protectionist sentiment, as they put it, in the United States. They said, what do you want us to do?

In a private meeting, we said, one, two, three, four. And, of course, No. 1 on our agenda was the dollar-yen relationship. Their kind of response, now, admittedly, something could get lost in

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translation or I could be a little naive, but their response was, well, we're glad to know that. We are really delighted to know that that's number one.

Subsequently, when Secretary Baker met with the Japanese, they have done at least their fair share to carry out the G-5 agreement, it seems to me.

So maybe the way we ask it and the fact that we ask it is pretty important. And I thank you for highlighting that.

Mr. WOLFF. If I could add one anecdote. One Congressman was traveling in Japan and he was asked by a member of the Japanese Diet, how was it that 92 Senators last year in a 92 to 0 vote voted to condemn Japan's trade policies? And he said, probably because the other eight Senators couldn't make it that day. [Laughter.]

Chairman LUNDINE. Mr. Pierce, you have got a lot of ideas I would like to ask you about, but time prohibits it. But your idea of a special Exim program for the developing countries is interesting.

As I recall, during the debt crisis, when it hit in 1982, the Eximbank itself proposed some special credits for Mexico and Brazil. But my general recollection is that nothing much happened as a result of that.

Am I correct, or can you clarify?

Mr. PIERCE. Actually, Exim, in both Mexico and Brazil, did take some extraordinary steps. But for the total Third World debt countries, looking at the entire category, Exim has been, in certain cases, hesitant. Let's take Morocco, for example that's one of the 15 countries included in the Baker plan. We recently put a case before them. Because Exim was anticipating rescheduling of debt in Morocco, they were not prepared to extend either their guarantee or direct credit for that transaction.

Now, we solved the problem using an off-country balance sheet leasing technique, and we used some political risk insurance that we have developed with Exim to shift to asset-based type financing. Because it's expensive, we are not anxious to see it done all the time, but we do congratulate Exim for working with us on developing the policy.

There have been other countries where they close the door because they anticipate a rescheduling.

The February 8 newsletter, by Morgan Guaranty comments how the Baker plan should, be more clear in one area that it is not at the present time. I am paraphrasing the report when I say: the official export agencies of the so-called rich nations, the OECD countries, should be tied into this program more effectively to enhance the ability of trade to flow on a coordinated basis. The Paris Club, public sector banking and the London Club, the private commercial banks, have to work more closely.

There has not always been the cleanest coordination between the Paris Club and the London Club in order to give it more stability or more coordination. If they could do a little better restructuring of some of these loans, perhaps through securitization, it would permit the Third World countries—once stable in their cash-flow requirements—to see some of the private sector growth benefits of privatization, and the return of flown capital.

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Chairman LUNDINE. I was just thinking, maybe if they had those negotiations in less appealling places than Paris and London, they wouldn't want to go back quite so fast. [Laughter.]

One additional question to you. Can you quickly tell me what is the basic purpose behind the proposal for a master guarantee program at the World Bank for big ticket items?

And second, if that were to be achieved, do you think it would allow our Eximbank to work with smaller companies to a greater degree?

Mr. PIERCE. Very much so. Because of the time constraint I didn't go into it earlier.

Somewhat akin to the question you are asking about 7J7-type aircraft, major capital goods components are being produced in many countries. What we have are international production consortia. For example, Airbus is manufactured, by five countries. The Boeing 767 is part Italian, part Japanese, part Canadian, but mostly United States content.

In order to level the playing fields on this export financing business, to achieve what we call pure cover, using guarantees, only no longer using direct credit or subsidized credit, and capitalizing upon the host of private capital market sources that are in London, New York, Tokyo, and so forth, the idea is to use a master guarantor like the World Bank. If we find the central guarantor who can then be used to tap either New York, London, or Tokyo, regardless of which international export consortium is competing—the competitors are all going to start on an equal basis with the master guarantee be it an Airbus, be it a Boeing, be it McDonnell Douglas, or whatever. The World Bank would go a long, long way in assisting to level these playing fields. And, the World Bank would collect a guaranty fee.

So, by getting into a rationalized, overall coordinated structure, and interfacing more with multinationalized consortium private sector, they are going to render a service of good, sound, equal, fair trade playing rules and at the same time, they are going to also probably gain a guarantee fee out of this. All the export agencies who would submit their guarantee to the World Bank. The World Bank would then provide the master guarantor.

In that way, Airbus could tap New York or Boeing could tap London or Tokyo and we would all be tapping on the same equal playing field.

Chairman LUNDINE. I want to thank all of the witnesses——

Mr. MCCANDLESS. Mr. Chairman?

Chairman LUNDINE. Oh, yes. I have taken a long time. You certainly can.

Mr. MCCANDLESS. This is kind of a $64 question. You can answer it if you wish.

The Inter-American Development Bank is having its annual meeting next week, I think it is. If you were part of that program and an advocate of a certain subject, what priorities would you be advocating? What would you be suggesting on that agenda of that board of directors and governing body?

Dr. Stern, do you have any thoughts on that?

Mr. Wolff.

Mr. Tucker.

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Mr. Pierce.

Mr. PIERCE. Well, one idea was the mutual fund concept.

Mr. MCCANDLESS. I am sorry. I didn't catch that.

Mr. PIERCE. The so-called mutual fund development program. I think they were sponsoring that idea, trying to find private investment through a mutual fund, which might be a way to draw various sources of capital, that have flown from the LDC's, back in a more unified fashion. Though not the panacea, but it's a plus to encourage private investment.

Mr. MCCANDLESS. Yes.

Mr. TUCKER. If I could take up that question. One of the problems with multilateral development banks is that they really don't have a great deal of command over increasing their own resources. They are structured into their own portfolios by what the member governments have given them.

So their room for leeway is pretty limited. They have opportunities for innovative thinking, which certainly is one thing that should be on their agenda. But the other side is raising the question of what their proper role is. Should they be taking a more activist approach? Should they be buying off some of the commercial bank lending?

These are questions that they really can't decide. The donor countries, those who supply the capital to the Bank, have to make those decisions.

Mr. WOLFF. I would have the U.S. Governor say what he probably will say in any event, that the countries that are recipients of assistance should improve the climate for private investment and that they should remove trade distortions.

But I think that the others at the meeting would answer that their major problem lies in insufficient flows of capital from the developed world and they would be right, and the problem will have to be solved among the developed countries, if the suggestions of the U.S. Governor that I have hypothecated would be acceptable.

Mr. MCCANDLESS. Thank you. Thank you, Mr. Chairman.

Chairman LUNDINE. I think all of the witnesses today have stressed the crucial point that we have more at stake in the United States in addressing the debt problem than simply the bottom line for big banks.

We have jobs. We have industrial development. And we have the entire international trading system being open and reasonably fair at stake in addressing this debt problem.

I want to thank you because you have been so cogent and so helpful in explaining the link between our own self-interest in the United States in terms of jobs and in terms of the success of our enterprise, with the seemingly far off problems of debt, particularly in Latin America.

It has been very helpful to this subcommittee. I am not sure that we have got all the answers as to how to bring it into sharper focus, but I think that you have helped greatly in that process. And from the standpoint of industries that are struggling for markets, in this case, perhaps pretty successfully, and thinkers who are studying these things, negotiators who have that experience, and even our own quasi-judicial system, we have gotten, I think, a

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much better perspective on the debt-trade link, and I thank you very much for it.

I hope that we will not fumble the ball, that we will be able to carry it and announce some public policy prescriptions that at least advance the cause of opening up the trade opportunities at the same time as we address the debt problems.

Thank you all very much.

[Whereupon, at 12:16 p.m., the subcommittee recessed, to reconvene on Thursday, March 20, 1986, at 10 a.m.]

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THIRD WORLD DEBT LEGISLATION

THURSDAY, MARCH 20, 1986

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:07 a.m., in room 2220 of the Rayburn House Office Building, Hon. Stan Lundine (chairman of the subcommittee) presiding.

Present: Chairman Lundine; Representatives Torres, Bereuter, and McCandless.

Chairman LUNDINE. The Subcommittee on International Development Institutions and Finance will come to order.

This morning, we are concluding a series of hearings regarding the possibility of taking up a legislative proposal to address the debt crisis in developing countries and its effect on the U.S. trade position.

I would ask unanimous consent that the opening statement that I have prepared here be a part of the record.

Without objection it will be.

[The opening statement of Chairman Lundine follows:]

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March 20, 1986

OPENING STATEMENT OF CONGRESSMAN STAN LUNDINE

CHAIRMAN OF THE SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT

INSTITUTIONS AND FINANCE

The Administration Response to Proposed Debt Legislation

This morning we conclude our series of four hearings on a legislative proposal to address the serious problems brought about by the debt crisis in the developing countries.

Previous testimony has revealed a general consensus in favor of the proposal and more specifically on the need for Congressional action to help manage the developing country debt problem. This demonstration of support is gratifying and is helpful in generating the momentum to move forward.

There have, of course, been specific recommendations for how the legislation might be improved upon and refined. We welcome these suggestions and will devote serious consideration to all of them. I also want to reiterate that this legislative proposal is intended to be complementary to the Baker initiative. In this regard we look forward to hearing testimony from the Administration today. I am sure that Mr. Mulford and Mr. Bale will have several constructive suggestions of their own. We appreciate the Administration's willingness to comment on this legislation and I am hopeful we can work together in the weeks ahead to frame the best possible bill.

As I have mentioned previously, I expect the Subcommittee to proceed to markup of this bill on April 10th, immediately after returning from the Congressional Easter recess.

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Chairman LUNDINE. Usually, they write me a long opening statement and I summarize it much shorter. But today, I am going to expand slightly.

Classically defined, it's the job of the Legislature to set policy and of the executive to carry it out. I understand that no executive probably wants really to be told what to do. That's natural and it wouldn't change much from administration to administration and it wouldn't change much from Legislature to Legislature.

We have had some witnesses and some evidence in extensive hearings we held last year that suggests that there may be some policy change in the U.S. position with respect to debtor countries that has evolved in the wake of serious problems, not only in Latin America, but elsewhere. And it seems to some of us that some legislative initiative, therefore, may be important because we don't want to interfere with delicate negotiations of the administration or indicate to the administration how it ought to proceed with carrying out basic policy.

The fundamental question that I would be interested in the witnesses addressing today is if you have a problem with our legislating, do you think that there is no need for policy change by the United States, or do you feel that the situation does not warrant any particular departure from rather traditional U.S. attitudes toward the World Bank, the other multilateral development banks and its associated institutions?

Finally, I would like to comment that, at the request of the administration, I believe that—I don't want to talk for my colleague, but I believe Mr. Bereuter and I will together introduce by request the proposal for the MIGA authorizing legislation, and I expect we will do that today, or tomorrow at the latest.

I look forward to a debate about that as well. I don't mean that it's that controversial, but by introducing it, I think we are welcoming discussion and attention to be given to that issue as well.

I am delighted this morning to welcome again David Mulford, Assistant Treasury Secretary for International Affairs and particularly appreciate Harvey Bale, the Assistant U.S. Trade Representative, joining him to state administration policy with regard to trade negotiations.

We have been trying to understand the link between debt and trade and, I think, that both of you can contribute greatly to our understanding as to whether there are initiatives which need to be carried out in order to open up trade opportunities or to deal with the situation where debtor countries seem unable to carry out normal trade relationships.

I want to finally emphasize that anything that I will propose to do will, in my own view, at least, be complementary to the so-called Baker initiative, not contradictory to it.

I welcome the administration's statement of what I consider to be a major policy initiative last fall, and insofar as that addresses the debt problem and also opens up possibilities for improved trade relations between the United States and some of the debt-ridden developing countries, I really welcome that initiative. And anything that I will be proposing, anyway, would be, from my perspective, at least, in the view of advancing that initiative, not sidetracking it.

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Mr. Bereuter, do you have a statement?

Mr. BEREUTER. Thank you, Mr. Chairman.

I join you in welcoming the two witnesses today, distinguished members of the administration. I look forward to their testimony. I will forego the opportunity for an opening statement and simply say that, indeed, I have decided to join you in introducing the legislation which would authorize MIGA at least to do that at the request of the administration.

I should also say that Republican Members of the Banking Committee, in the course of deciding what our recommendations would be to the Budget Committee for fiscal year 1987, decided, without dissent, not to seek an authorization for MIGA for fiscal year 1987. And that is strictly a budgetary consideration and does not suggest a lack of support for the concept.

Indeed, there is support for the concept and we want to provide an opportunity to authorize in general the creation of MIGA.

I think that's all I have to say at the moment, Mr. Chairman. I am looking forward to the testimony.

Chairman LUNDINE. Thank you, Mr. Bereuter.

Gentlemen, your entire written statement is appreciated. We did receive it in advance. It will be made a part of the record.

You may proceed as you wish. Mr. Mulford.

STATEMENT OF HON. DAVID C. MULFORD, ASSISTANT TREASURY SECRETARY FOR INTERNATIONAL AFFAIRS

Mr. MULFORD. Thank you, Mr. Chairman.

I have, in addition to the written statement which we, submitted for the record, a briefer summary statement that I would like to read. I think it's important to set the stage from the administration standpoint on the overall debt strategy in a general way. I think it will be helpful to our discussions here today and to the questions that come later.

First, let me begin by saying that the draft bill offers several relevant suggestions which I would like to discuss later. But I would like to stress at the outset of our testimony that the administration does not see a need for legislation at this time to implement the debt strategy, as a general proposition.

The current international debt crisis is one of the greatest challenges, I think, that has faced us since the Great Depression and the Second World War period, and it has that element of insolubility which brings out our worst frustrations.

The U.S. economy has been seriously and adversely affected by the debt situation. U.S. exports to developing countries have slumped. Our financial institutions have had to bolster their reserves. And the demands on the Federal budget for foreign assistance have intensified.

If we manage the debt situation responsibly and wise, these adverse effects should recede in the future.

Managing the debt problem, let alone eventually solving it, requires two critical operating assumptions. First, we must honestly recognize that there are no easy solutions. Second, no matter how overpowering the problem appears to be in its totality, we must focus our efforts on those elements that are soluble.

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The U.S. debt initiative recognizes the fundamental need for growth. We believe that without growth, there can be no solution to the debt problem. Countries must expand their debt-servicing capability, real income, and export earnings at a faster pace than they are accumulating debt.

We also firmly believe that without economic reform, no amount of money, whether derived from external borrowing, foreign assistance, or inflationary domestic pump-priming, will produce sustained growth.

Credible reform by the debtor nations will improve their growth prospects, but debtor nations simply cannot be expected to grow and adjust simultaneously without additional external finance. Linked with credible reform, the other two elements of the debt strategy provide for the sources for this finance: net new lending by the commercial banks and enhanced flows from the international financial institutions.

These three mutually reinforcing elements form the working heart of the debt strategy.

It is also important to emphasize that the debt initiative does not operate in a vacuum or in isolation from other critical economic issues. Recent developments in the global economic environments are improving prospects for developing countries and for our own economy.

There has been a substantial reduction in interest rates. LIBOR currently stands at approximately 7.6 percent, as compared to 10.2 percent 1 year ago. Each percentage point decline reduces the debt service on commercial loans to the 15 major debtor nations by $2½ to $3 billion.

The dramatic decline in crude oil prices gives most developing countries financial relief on their oil imports. The estimated 1-percent increase in OECD growth will stimulate exports, and as inflationary expectation subsides further, there should be additional interest rate relief.

We are already seeing interest rates fall in some major industrialized countries.

Even some of the oil-exporting countries will be offsetting their lost export earnings with reduced interest rate costs.

The 25- to 30-percent decline since September in the U.S. dollar versus the yen and the deutsche mark should make imports from the United States more competitively priced in all developing country markets. If other key industrial nations do their part improving domestically generated growth, maintaining or improving access to markets, and continuing the economic and financial cooperation of recent months, I see greater scope for continued growth, reduced inflation, and further reductions in interest rates over time.

The rapidly approaching meetings of the Interim Development Committees, the OECD Ministerial Meeting, and the Tokyo Economic Summit will be opportunities to continue cooperation on these matters so important to resolving the debt situation in the developing countries.

The response to the U.S. debt initiative from all quarters has been positive and confirms our conviction that the focus of the initiative on credible, growth-oriented reform in the debtor countries, supported by net new lending by the commercial banks and en-

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hanced by policy-based lending from the international financial institutions, is essential. Our focus on the three main elements for resolving the debt problem is widely agreed by all key participants to hold the greatest hope for realistic forward momentum.

The initiative is now in place and is being implemented. What must happen now to make the strategy work?

First, the debtor nations must reform their economies so that they can grow. The debtor nations need to examine intensely opportunities for privatization of public enterprises, the development of more efficient domestic capital and equity markets, growth-oriented tax reform, improvement of the environment for both domestic and foreign investment, trade liberalization, and the rationalization of import regimes.

I recognize that many of these touch on sensitive political issues, while their benefits may become visible only over the longer term. Such reform is difficult and takes time.

But in recent weeks we have seen a number of countries announce major policy changes. Argentina is initiating a significant privatization effort. Brazil has removed indexation as an element generating inflation. And Mexico has indicated willingness to explore new ways to attract foreign direct investment.

So this element of our debt strategy is gradually falling into place.

Second, commercial banks in virtually all of the major creditor nations have now indicated their willingness to support the U.S. debt initiative and to provide net new lending to debtor nations.

The banks know that without growth in the debtor nations and an improved ability to earn foreign exchange, they cannot expect to be repaid, nor, to put it bluntly, can they expect to continue favorable earnings on assets of declining quality.

It is sometimes suggested that we consider changes in the structure of U.S. capital markets or the regulation of private financial institutions in order to achieve a lasting resolution of the debt crisis.

I do not believe this is necessary at this time. Indeed, it could be counterproductive, because it suggests some form of generalized changes in the U.S. practice can bring about a lasting global solution to the debt crisis.

The reality is that the changes that are necessary in large degree are external to the United States.

This brings me to the third element of the debt initiative—the contribution from the international financial institutions.

I would underscore at the outset that the IMF must continue to play its central role in the overall debt strategy. Enhanced roles for the World Bank and other multilateral development banks will be supplemental to the IMF's role, not a substitute for it.

The World Bank's mission is focused on longer term development issues and it already has experience in addressing some of the types of structural problems that most debtor countries face. Most of the World Bank's new lending will be fast-disbursing sectoral and structural adjustment loans.

We believe the World Bank has ample capacity to increase such lending by some $2 billion per year over the next 3 years and to

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concentrate that lending more heavily on the large debtors with credible reform programs.

The expanded role for the World Bank in the debt initiative is not limited to policy-based lending. An important element of economic reform in almost all debtor nations is the need to strengthen the role of the private sector. A major World Bank tool for this purpose is the proposed Multilateral Investment Guarantee Agency, or the so-called MIGA.

I understand that you have received the administration's legislative proposal and I am very pleased to understand that you will jointly support its introduction in the near term.

Let me emphasize that the impetus to achieve this long sought U.S. objective—that is to say, to actually implement it—should not be dissipated by waiting. Early authorization for U.S. membership and full funding is important to the success of our overall international efforts and your support for this is essential.

I should mention briefly another key funding question related to the World Bank. We are prepared, if all the participants in the debt strategy do their part, and there is a demonstrated increase in the demand for quality lending, to consider a general capital increase for the World Bank.

An alternative to a capital increase which has been advanced is a change in the gearing ratio of the Bank.

In my prepared statement I discuss this matter at some length. But, in brief, for the purpose of summary here, I would like to say first that the proposal would have an adverse effect on investors in World Bank securities. It would narrow the world market for World Bank securities. It would come at a time when other substantial changes in the Bank's lending policies are taking place. And finally, it would raise borrowing costs to the Bank and lending rates to its clients.

We, I think it's obvious, firmly oppose this idea. Indeed, I would add that if this idea surfaces in a more visible way, it will do damage, in my opinion, in the financial markets because the perceptions will begin to change and there will be uncertainty. The first effect, in my opinion, will be to increase the spread between World Bank paper and Treasury securities in the marketplace and cause some of the things I mentioned to begin happening even if the legislation never is in fact enacted.

The mere proposal and threat of such legislation would have financial impacts in the market.

As you know, Mr. Chairman, we are seeing a number of specific reforms in the replenishment negotiations for the Inter-American Development Bank. We are hopeful that we can make significant progress on these points next week as member countries convene for the Bank annual meeting in San Jose, Costa Rica.

To put in place the financial underpinnings for future Bank lending, the member governments have negotiated a merger of the ordinary capital and inter-regional capital accounts of the Bank. This merger will allow more efficient use of Bank capital. United States agreement to the proposal requires legislative action and I urge your prompt and favorable consideration. Before concluding, I would like to add a somewhat related comment.

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I understand that you are contemplating requirements for a series of reports on a number of topics. Mr. Chairman, I can only say that Gramm-Rudman-Hollings is real and its effects on the Treasury Department are real. I and my staff stand ready to meet with the subcommittee formally or informally at the call of the Chair. But the expense of written reports would be very hard at this time for us to justify.

With this plea to you to cooperate with our efforts to reduce expenditures, I now look forward to hearing your views on the debt initiative and to answer questions which you may have.

Thank you very much.

[The prepared statement of Mr. Mulford follows:]

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FOR RELEASE UPON DELIVERY
MARCH 20, 1986
EXPECTED AT 10:00 A.M.

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT INSTITUTIONS
AND FINANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
MARCH 20, 1986

Mr. Chairman, Members of the Committee, thank you for inviting me to discuss the U.S. debt initiative and where it stands. The draft bill you have sent offers several relevant suggestions which I would also like to discuss. But I would like to stress at the outset that the Administration does not see a need for legislation at this time to implement our debt initiative.

The current international debt crisis is one of the greatest challenges for the world economy and financial system since the Great Depression. It has that element of insolubility which brings out our worst frustrations.

The U.S. economy has been seriously and adversely affected by the debt situation. U.S. exports to the developing countries have slumped. Our financial institutions have had to bolster their reserves. And the demands on the Federal Budget for foreign assistance have intensified. If we manage the debt situation responsibly and wisely, these adverse effects should recede in the future.

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Managing the debt problem, let alone eventually solving it, requires two critical operating assumptions. First, we must honestly recognize that there are no easy, all encompassing global solutions. Second, no matter how overpowering the problem appears in its totality, we must focus our efforts on those elements of the problem that are soluble and where we can be effective.

Herein lies the importance of the U.S. debt initiative. It recognizes the fundamental need for growth. It places the objective of increased growth and the reforms necessary to promote growth at the center of the debt strategy.

We believe that without growth there can be no solution to the debt problem. Countries must expand their debt servicing capability -- real income and export earnings -- at a faster pace than they are accumulating debt.

We also firmly believe that without economic reform, no amount of money -- whether derived from external borrowing, foreign assistance, or inflationary domestic pump-priming -- will produce sustained growth.

Credible reform by the debtor nations will improve their growth prospects, but debtor nations simply cannot be expected to grow and adjust simultaneously without additional external finance. Linked with credible reform, the other two elements of the debt initiative provide for the sources of this finance: net new lending by the commercial banks and enhanced flows from the international financial institutions. These three mutually reinforcing elements form the working heart of the debt initiative.

It is also important to emphasize that the debt initiative does not operate in a vacuum or in isolation from other critical economic issues. Recent developments in the global economic environment are improving prospects for developing countries and for our own economy:

-- There has been a substantial reduction in interest rates. LIBOR currently stands at approximately 7.6 percent, as compared to 10.2 percent a year ago. Each percentage point decline has reduced the debt service on commercial loans to the fifteen major debtor nations by $2.5 to $3 billion.

-- The dramatic decline in crude oil prices gives most developing countries financial relief on their oil imports, impetus to exports from the estimated one percent increase in OECD growth, and additional interest rate relief as inflationary expectations subside further. We are already seeing the interest rates fall in some major industrialized countries.

-- Even some of the oil exporting countries will be offsetting their lost export earnings with reduced interest rate costs.

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-- The 25 to 30 percent decline since September in the U.S. dollar versus the yen and deutsche mark should make imports from the United States more competitively priced in all developing country markets. Export opportunities should also improve for those economies whose exchange rates track closely with movements in the dollar.

There are good prospects for additional steps in the coming months which can add impetus to growth. First, the United States is implementing a credible deficit reduction program. All Branches of the U.S. Government recognize that we must get the U.S. deficit under control. Suggestions that involve budgetary outlays such as increasing purchases for the Strategic Petroleum Reserve should be viewed in that context. While they may have beneficial effects, they would require additional budget outlays and they further complicate the already difficult decisions which the President and the Congress will be facing in the coming weeks.

Second, the Congress and the Executive Branch are deeply engaged in tax reform, which can give impetus to private sector growth and initiative.

Third, the U.S. trade deficit in 1986 should be about $20 billion lower than we expected as recently as last fall. For 1987, the deficit should drop below $100 billion. This can be accomplished without resorting to protectionist solutions and with continued solid growth in the U.S. economy.

If other key industrial nations do their part -- improving domestically generated growth, maintaining or improving access to markets, and continuing the economic and financial cooperation of recent months -- I see greater scope for continued growth, reduced inflation and further reductions in interest rates over time.

The rapidly approaching meetings of the Interim and Development Committees, the OECD Ministerial Meeting and the Tokyo Economic Summit will be opportunities to continue cooperation on these matters so important to resolving the debt situation in developing countries.

The response to the U.S. debt initiative from all quarters has been positive and confirms our conviction that the focus of the initiative on credible, growth-oriented reform in the debtor countries, supported by net new lending by the commercial banks and enhanced by policy-based lending from the international financial institutions is essential. Our focus on the three main elements for resolving the debt problem is widely agreed by all key participants to hold the greatest hope for realistic forward momentum.

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The initiative is now in place and is being implemented. What must happen now to make the strategy work?

First, the debtor nations must reform their economies so that they can grow. While there have been commendable efforts to deal with the debt problems during the past three years, a number of important structural reforms are needed to lay a firm foundation for stronger growth and to reverse the capital flight which has plagued these economies. The debtor nations will need to examine intensely opportunities for privatization of public enterprises, the development of more efficient domestic capital and equity markets, growth-oriented tax reform, improvement of the environment for both domestic and foreign investment, trade liberalization and the rationalization of import regimes.

I recognize that many of these touch on sensitive political issues, while their benefits may become visible only over the longer term. Such reform is difficult, and takes time.

We have heard the suggestion that trade liberalization should play a central role in reform efforts. While this is often true, I would stress that reforms must be tailored to the situation of each debtor nation. No single element should be seen as a necessity for policy-based lending from the development banks. Nor should the United States seek to impose its own bilateral trade objectives on these loans. That would be counterproductive.

Our first goal needs to be to encourage economic reform which will generate growth and relieve debt constraints, and in some cases, liberalization of restrictive trade practices is important. However, finance needed to support reform will only be made available if these reforms are credible, with reasonable prospects for long-term success.

Second, commercial banks in virtually all of the major creditor nations have now indicated their willingness to support the U.S. debt initiative and to provide net new lending to debtor nations. If reform in the debtor countries is implemented in a credible manner, the banks can only gain from providing additional financing which improves the creditworthiness of their existing clients.

The banks know that without growth in the debtor nations -- and an improved ability to earn foreign exchange -- they cannot expect to be repaid, nor, to put it bluntly, can they expect to continue favorable earnings on assets of declining quality.

Traditionally, banks have worked with troubled clients, because they have believed it to be in their own self-interest. The present international debt situation is no different. Indeed, there is more at stake for the participating banks in all the creditor nations, because they share the same international and interdependent financial system.

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It is also suggested that we consider changes in the structure of U.S. capital markets or the regulation of private financial institutions in order to achieve a lasting resolution of the debt crisis.

I do not believe this is necessary at this time. Indeed, it could be counterproductive, because it suggests some form of generalized changes in U.S. practice can bring about a lasting solution to the debt crisis.

The changes that are necessary in large degree are external to the United States: adjustment by the debtor nations, support from the IMF and increased lending from the commercial banks and the MDBs. Changes in U.S. banking regulations will not reestablish the creditworthiness of countries, provide the new financing necessary to promote growth, nor instill the confidence necessary in domestic populations to lead to a return of flight capital.

The heads of the U.S. regulatory agencies already are on record as stating that new lending to countries making appropriate adjustment efforts can improve the quality of outstanding loans. I believe that the U.S. financial system and U.S. regulatory agencies are sufficiently flexible that they can accommodate and deal with specific issues on a case by case basis, as they arise.

The commercial banks are being called upon to increase their exposure by a modest 2.5 to 3 percent annually, while the World Bank is being asked to increase its lending by an amount equivalent to an annual increase in total exposure of about 20 percent. The provision to commercial banks of World Bank guarantees or of some sharing of the Bank's "preferred creditor" status through subtly crafted cofinancing arrangements would essentially transfer risk to governments, voiding the modest increase in commercial banks exposure. While the desire for such measures is understandable, we do not intend to support them to induce increased bank lending.

This brings me to the third element of the debt initiative, the contribution from the international financial institutions. I would underscore at the outset that the IMF must continue to play its central role in the overall debt strategy. Enhanced roles for the World Bank and the other multilateral development banks will be supplemental to the IMF's role, not a substitute for it.

We have asked the IMF to give more thought to growth-oriented policies and this is being done. But given the IMF's central mission (which is not that of a development institution), and its need to concentrate its resources on relatively short balance of payments programs, the Fund's contributions will necessarily focus on macroeconomic policy, rather than long-term structural reforms.

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The World Bank's mission, on the other hand, is more strongly focused on longer-term development issues and it already has experience in addressing some of the types of structural problems that most debtor countries face. Most of the World Bank's new lending will be fast-disbursing sectoral and structural adjustment loans. We believe the World Bank has ample capacity to increase such lending by some $2 billion per year over the next three years and to concentrate that lending more heavily on the large debtors with credible reform programs.

An expanded role for the World Bank will require important policy and procedural changes in the Bank. This is a difficult but indispensible exercise, for two reasons:

-- First, it is hard to change large, mature organizations with firmly established bureaucracies.

-- Second, an expansion of fast-disbursing loans must, and I repeat must, be accomplished without dilution of the quality of World Bank lending.

Indeed, it will be essential to improve the quality of conditionality of lending with the World Bank if sectoral lending is to be increased. Any increase in fast-disbursing lending by the Bank which fails to maintain loan quality will result in a serious risk of over-exposure and a diminished international credit standing for this important international institution.

It will also be essential for the IMF and the World Bank to establish a closer working relationship. I realize this is easy to say, and hard to accomplish. But the member governments of both institutions must insist that some pragmatic method of closer cooperation be developed if economic reform in the debtor nations is going to be credible enough to command additional resources from private banking institutions.

The expanded role for the World Bank in the debt initiative is not limited to policy-based lending. An important element of economic reform in almost all debtor nations is the need to strengthen the role of the private sector. A major World Bank tool for this purpose is the proposed Multilateral Investment Guarantee Agency, or the "MIGA."

The MIGA is designed to encourage the flow of investment to and among developing countries by issuing guarantees against political risk, carrying out a wide range of promotional activities and encouraging sound investment policies in member countries.

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The United States has long been an advocate of a greater role for foreign direct investment in the development process. Foreign direct investment both enhances the private sector's role and encourages the flow of non-debt capital, which can expand productive capacities and facilitate the structural changes which are essential to resolving the debt problem. Despite its advantages, foreign direct investment declined from 20.4 percent of total capital flows to developing countries in 1975 to 10 percent in 1984.

Perceptions by investors of restrictive investment policies, especially uncertainties about the transfer of returns on investments, appear to have contributed to the reduction in direct investment flows. Policies that distort or impede international investment flows conflict with the obvious needs of developing countries for capital. The MIGA, with its strong mandate to encourage reforms, will stimulate the flow of foreign direct investment to these countries.

I understand that you have received the Administration's legislative proposal, but there is real reluctance to initiate a new program in the current budgetary environment. Let me emphasize that the impetus to achieve this long sought U.S. objective should not be dissipated by waiting. A delay would disrupt the international efforts now underway to encourage the flow of equity investment to developing countries. The MIGA clearly advances our interests: it supports our development policy, reinforces our international debt strategy and will result in further investment flows to the developing nations. Early authorization for U.S. membership and full funding is important to the success of our overall international efforts. Your support is essential.

I should touch on another key funding question related to the World Bank before turning to other matters. We are prepared, if all the participants in the debt strategy do their part and there is a demonstrated increase in the demand for quality lending, to consider a general capital increase for the World Bank. This Committee will carry the responsibility for convincing your colleagues in the House that any such capital increase is justified. We will need your guidance and views during negotiations of this subject, if conditions emerge which warrant consideration of a capital increase.

An alternative to a capital increase which has been advanced is a change in the gearing ratio of the Bank. Presently, the Bank can not have outstanding disbursements in excess of subscribed capital, reserves and surplus. We oppose any change in this limitation. We would cite three simple reasons.

First, the change in the gearing ratio would be a fundamental change in the nature and amount of financial resources which stand behind the securities offered by the Bank to investors. Bluntly:

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-- we would risk raising the cost of funds to the Bank and the cost of Bank loans to all borrowers, and

-- we would risk reducing the pool of investors prepared to invest in Bank securities to the point where

-- we are uncertain that even the existing lending program could be funded.

Second, the timing could not be less propitious. With our support the Bank is currently modifying the nature of its lending operations fundamentally. Investors see that a growing portion of Bank loans are going to support policy changes, rather than infrastructure projects which promise to earn foreign exchange. While we support this shift because it promises the most effective means of dealing with the debt situation, we can understand that investors may be watching carefully. To add a fundamental change in the Bank's financial structure which diminishes the relative amount of shareholder resources at risk would be highly imprudent.

Third, the budgetary savings which presumably would be the point of the gearing ratio change can be achieved by making subscriptions in the form of callable capital which do not necessarily entail budget outlays. It would be premature to discuss now the need for additional capital. But callable capital is well-understood by the investment community, raises none of the disadvantages of a gearing ratio change and, if there is no paid-in element, has no impact on the Federal budget. In short, I see no advantage -- practical or theoretical -- to a gearing ratio change, when compared to callable capital.

Several other suggestions for changes in the World Bank are useful contributions. First, we can support an increase in the amount of structural adjustment lending. The ten percent ceiling is not a barrier. We are prepared to see it raised to accommodate the demand for well-conditioned loans designed to support reform programs.

Second, the idea of increasing the World Bank share of already approved, but unfinished projects was a prominent element of the Special Action Program in effect in 1983 and 1984. It may be appropriate in specific cases. However, if the purpose is to provide more foreign exchange in an appropriate policy context, the structural and sectoral adjustment lending programs can meet the same need without complicating project accounting and implementation.

Finally, I agree with the suggestion that reforming financial sectors can play a key role in several debtor nations. Clearly, sensitive political issues are involved and each country situation needs to be evaluated individually.

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Before concluding my thoughts on the debt initiative, I want to touch on the role of the Inter-American Development Bank. As you know, Mr. Chairman, we are seeking a number of specific reforms in the replenishment negotiations for the Bank. These reforms -- directed toward enhancing the Bank's ability to identify and negotiate appropriate policy conditions for its lending -- are essential if the Bank is to play a meaningful role in resolving the debt problems of borrowing countries in the region. We are hopeful that we can make significant progress on these points next week, as member countries convene for the Bank Annual Meeting in San Jose, Costa Rica.

To put in place the financial underpinnings for future Bank lending, the member governments have negotiated a merger of the Ordinary Capital and Inter-Regional Capital accounts of the Bank. This merger will allow more efficient use of Bank capital. In other words, the Bank will be able to lend on the basis of a smaller increment of capital subscriptions from members, than if the two accounts were to remain separate. U.S. agreement to the proposal requires legislative action, and I urge your prompt and favorable consideration.

Let me summarize by saying that if the U.S. initiative succeeds, we will see milestones keyed to specific countries. But we should not be looking for a series of major events in rapid succession. The debt situation involves a broad range of economic, financial and political elements, all of which need to be addressed.

The process is evolutionary. It will take time and will require patience, cooperation, political sensitivity, practical ideas, and steady application of the disciplines within the debt strategy to restore growth to the debtor nations. That is the challenge before us and the only real solution to the debt crisis.

Before concluding, I would like to add a somewhat related comment.

I understand that you are contemplating requirements for a series of reports on a number of topics. Mr. Chairman, I can only say that Gramm-Rudman-Hollings is real and its effects on the Treasury Department are real. Some weeks ago, I asked my staff to analyze existing reporting requirements to see which ones can be eliminated. We have several proposals. In this climate, the thought of doing additional reports does not seem realistic unless their legislative purpose is immediate. I and my staff stand ready to meet with the Committee formally or informally at the call of the Chair. But the expense of written reports would be hard for us to justify.

With this plea to you to cooperate with our efforts to reduce expenditures, I now look forward to hearing your views on the debt initiative and to answering questions you may have.

Thank you.

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Chairman LUNDINE. I would like to intervene here that the impact of Gramm-Rudman is very real on congressional budgets as well. So we are sensitive to the report requirements. In fact, it's not as though I want to disclaim any parentage for this draft discussion vehicle, but one reason I didn't want to introduce it as legislation is, that I said to the staff, I want to know how many reports we are asking for and when they are due and how they correlate with one another.

So I am not promising you no reports, but I will take you up on your offer that before we require any, we will have a dialog about it.

Mr. MULFORD. Thank you very much.

Chairman LUNDINE. Mr. Bale.

STATEMENT OF HON. HARVEY BALE, ASSISTANT U.S. TRADE REPRESENTATIVE

Mr. BALE. Thank you, Mr. Chairman, I hope in your review of that issue of reports, and when you're looking around for a group of individuals or institutions to prepare them, I hope that you take into account our own agency's limited staff resources and the fact that we already produce several reports for the Congress. Perhaps this is an area for greater privatization. [Laughter.]

Chairman LUNDINE. We will be glad to take reports from private organizations, if you would rather that be the case. [Laughter.]

Mr. BALE. I am pleased, Mr. Chairman, to have the opportunity to comment on the major elements in the draft legislation before the subcommittee, focusing in particular on the trade aspects that are designed to encourage LDC trade liberalization and reduce the U.S. trade deficit.

The draft bill reflects, I believe, considerable concern with the need to ease the U.S. trade deficit while encouraging LDC expansion, and it properly puts the focus of that concern on expanding world trade rather than restricting world trade.

The administration's trade concerns have been backed up by action on several fronts. These include the commitments negotiated with the G–5 countries on domestic macroeconomic policy adjustments and the dollar, the President's commitment to Federal budget deficit reduction, the Baker initiative last fall, and the trade initiatives announced by the President last October to reduce unfair trade practices, as well as efforts to launch a new round of multilateral trade negotiations.

The United States has felt the repercussions of the LDC debt crisis with its necessary adjustments for our trade account. With regard to the key debtor countries recently identified under the recently announced U.S. debt initiative, the United States has experienced a 32-percent decline in exports and a 13 percent increase in imports since 1981, and a trade deficit which has grown from $3.3 billion in 1981 with these countries to $21.3 billion in 1985. In 1981, nearly 17 percent of total U.S. exports were shipped to these countries; by 1985, that figure had dropped to 12.6 percent.

In the back of my testimony, I put together some data with the help of our colleagues both here in USTR and the Treasury Department and elsewhere showing some of the macroeconomic changes

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that have taken place. I refer the committee to those data for perhaps later discussion.

From a trade perspective, at least three aspects of the process of LDC adjustment to date have been problematic to U.S. and global trade interests.

First, a substantial part of the improvement in high-debt LDC's trade and current account improvements have been reflected in weakened U.S. trade and current account balances and in weakened U.S. exports.

Second, a number of developing countries have compounded the distortive policies which act to restrict imports in order to promote exports.

Third, the full recovery of world trade and growth will continue to be hampered until policy adjustments permit stronger economic growth in the high-debt LDC's without sacrificing the progress being made to resolve their internal economic distortions and external debt difficulties.

The plan announced by Treasury Secretary Baker in Seoul, Korea in October last year presents an opportunity to address these concerns. The U.S. debt initiative is a three-part program as described by the assistant secretary and the administration is fully behind that approach, all agencies involved.

The administration strongly believes that trade and investment barriers must be reduced—a major part of this plan—to stimulate sustained, substantial growth in the developing countries. Also, our efforts to open up a new round of multilateral trade negotiations in the GATT are intended to further these objectives.

The new U.S. initiative on debt, coupled with the new trade round, offers an excellent opportunity for greater cooperation between the World Bank and the GATT. This is an issue that is addressed in your draft legislation.

There is an important cooperative relationship that can and should exist between the World Bank and the GATT. It is suggested in the proposed legislation that trade liberalization undertaken in the GATT be rewarded by additional appropriate public and private capital. Trade liberalization in the GATT certainly contributes to some of the policy reforms that the World Bank and the commercial banks seek as a condition for increased lending if only because they foster sustainable growth.

However, we should also look at another aspect of this GATT/Bank relationship. The potential exists that when World Bank programs support trade and investment liberalization measures, such measures can and should be taken into account in the framework of the GATT. This approach has been used productively in the past.

For example, during the Tokyo Round, the United States took into account trade liberalization measures under the IMF programs as long as those measures were bound in the GATT.

That brings out an important difference perhaps between the GATT and the Bank.

The Bank may make efforts to eliminate quantitative restrictions on imports which have substantial potential benefits for U.S. exports. If developing countries, as a followup to those Bank programs, are prepared to bind those concessions in the sense of making contractual arrangements to contain those liberalizations

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for a period of time that extends well beyond the period of the bank loans and, in principle, in perpetuity, then that is a contribution that we can take into account in the GATT. This is because that allows both the developing countries, the Bank and the GATT to benefit through these liberalizations.

There can be significant benefits to developed and developing countries from such cooperative approaches among the multilateral development banks, IMF, and the GATT. The World Bank and the IMF can help countries take necessary structural reforms, including trade and investment liberalization, that will expand economic development and growth. In turn, developing countries will be able to secure access to markets in the developed countries under the GATT framework. This also will foster national growth and development.

In this context, I should mention that we in the trade field are already working to encourage a greater contribution from our major industrialized trading partners toward aiding LDC debt adjustment. This is another problem that is identified in the draft legislation: that is, what are our trade partners—the Japanese, the European Community—doing to foster greater economic growth among the LDC's?

The United States remains by far the industrial market most open to LDC exports. Exports of manufactures are critical for LDC's, both because their prices are less subject to fluctuation than commodities and because expanding manufacturing production is important, but not exclusively important, to the development process.

In 1984, the United States received 62 percent of all manufactured products shipped by the LDC's to the industrial world. The European Community's share was only 23 percent and Japan's was a meager 8 percent.

The openness of our economy to LDC exports is a function of our relatively more liberal trade policy, regardless of the overall balance in U.S. trade. In 1981, even when the United States had over a $6 billion surplus on the current account, we still received more than half of the LDC manufactures exports to the industrialized world.

We strongly encourage our trade partners to roll back protectionist restrictions against LDC imports. We will continue to do so in a new round of multilateral trade negotiations. Although Japan and our European allies provide a higher proportion of their economic assistance as a share of gross domestic product, their foreign assistance is frequently in the form of commercially motivated tied-aid credits. Such practices often serve to further distort world trade and are strongly opposed by the U.S. Government.

As we press our major trading partners to open markets, we must be careful that negotiations on trade liberalization take place as much as possible in a multilateral framework and not one restricted to a limited number of countries. Only through a multilateral approach to trade and investment liberalization can export markets expand sufficiently to help remedy the debt problems of developing countries.

This process already is underway and, with developing country participation, those trade negotiations will foster an expansion of

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the world trading system and sustain economic growth and development.

The proposed bill also calls for additional purchases of oil by the U.S. Government and other developed countries, especially those with current account surpluses. Aside from the budgetary constraints on the U.S. Government in making such additional purchases, we wonder whether we should focus primarily on increasing developing country oil exports.

As I mentioned earlier, our industrial trading partners take much smaller proportional volumes of imports of manufactures from developing countries. Japan, indeed, has a large trade surplus with its nonoil producing trade partners in Asia. These are some of the countries with whom we have the largest trade deficits.

We hope that our efforts to liberalize trade barriers in Japan will benefit not only United States exports, but also developing country exports.

In addition, European Community restrictions and subsidies on agricultural exports impair not only United States trade, but also the trade of Latin American and certain Asian exporters who export agricultural products.

Thus, we should focus our attention on increasing imports by Japan and the European Community from the United States and developing countries in categories that range from agriculture to industry.

In conclusion, I would just like to say that the administration is already directly focusing on many of the issues of concern to the committee in the draft legislation. We, like the Treasury Department, do not believe that legislation is essential now to carry out the objectives that the committee has properly set, that is, to seek trade liberalization in developing countries, along with the financial aspects of the legislation.

The United States debt and trade initiatives to assist both growth and adjustment in the high-debt LDC's, the increased emphasis on growth-oriented reforms, and efforts to obtain a greater contribution from Japan and Europe toward LDC adjustment will receive the firmest support from the United States Trade Representative's office.

Thank you very much.

[The prepared statement of Mr. Bale follows:]

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STATEMENT BY
DR. HARVEY E. BALE, JR.
ASSISTANT U.S. TRADE REPRESENTATIVE
FOR INTERNATIONAL TRADE POLICY AND ANALYSIS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT INSTITUTIONS
AND FINANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
MARCH 20, 1986

I am pleased to have this opportunity to comment on the major elements in the draft legislation before the Subcommittee on International Development concerning the multilateral development banks. I will concentrate my remarks on those aspects of the bill designed to encourage LDC trade liberalization and reduce the U.S. trade deficit. The draft bill reflects considerable concern with easing the U.S. trade deficit while encouraging LDC expansion.

Need to Reduce the U.S. Trade Deficit in the Context of Expanding Trade

The Administration is particularly concerned with the need to reduce the U.S. trade deficit and the imbalance in global payments. It is of paramount importance that we and other nations act to relieve these current international imbalances in a fashion that promotes, rather than restricts, world trade and growth.

The Administration's trade concerns have been backed up by

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actions on several fronts. These include the commitments negotiated with the G-5 countries on domestic macroeconomic policy adjustments and the dollar, the President's commitment to Federal budget deficit reduction, the trade initiatives announced by the President last October to reduce unfair foreign trade practices, and efforts to launch a new round of multilateral trade negotiations.

The Recent Pattern of LDC Adjustment to the Debt Crisis

Heavy borrowing by developing countries in the 1960s and 1970s supplemented domestic savings and helped sustain high levels of investment and growth. Foreign borrowing financed large LDC trade and current account deficits which in turn facilitated imports of plant, capital equipment and other materials vital to the development process. U.S. trade was a major beneficiary of this process as exports of capital goods to developing countries became one of the principal sources of U.S. export growth in the 1970s. For example, U.S. machinery exports to developing countries increased by 150 percent from 1975 to 1981, as compared to a 109 percent increase in these exports to other developed countries.

For most of the countries that are now suffering from debt-servicing problems their foreign borrowing was excessive which, combined with their poor economic policies, sowed the seeds for the present economic difficulties. Over the 1973-83 period, the

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foreign debt of these countries grew much faster than both output and export revenues, a clearly unsustainable rate. Not only was foreign borrowing excessive in terms of volume in many countries, it was used for uneconomic projects or was never invested at all as it left the country through capital flight.

In the early 1980s this process came to a halt, creating a crisis for the servicing of the accumulated foreign debt of many LDCs. The necessary adjustment process in the industrial countries to high energy prices and to reduce inflation led to slower growth and lower commodity prices which, in turn, reduced LDC export earnings. Rising interest rates increased the cost of servicing the excess debt built up by many LDC's. The financial strains which resulted tended to increase the risk faced by private lenders to many high-debt countries. At the same time, it became increasingly apparent that inappropriate economic policies, including those regarding trade and investment in developing countries had limited the economic return on past investment, and in many cases, the LDC borrowers' ability to repay the foreign debt. The result was a general drying up of net new private lending to the high-debt LDCs. (See Table 1)

Table 1

Bank Lending to W. Hemisphere LDCs

($ Billion)

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Year	Net New Lending
1983	15.0
1984	7.6
1985 (I-III)	- 0.3

Taken together, these developments required the highly indebted LDC's to make severe balance-of-payments adjustments. Current accounts were reduced from large deficit to balance or even surplus. Domestic saving was not raised to fully offset the loss of foreign borrowing and continued capital flight. As a result, domestic investment fell and economic growth came to a halt. Current account adjustment was thus achieved in part by substantial reductions in imports. (See Tables 2 and 3)

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Table 2

Annual Compound Growth Rate of Real Imports

(Percent)

	1968 to 1980	1980 to 1985
W. Hemisphere LDC's	7.0	-7.9
All High-Debt LDCs	6.8	-5.7

Table 3

Current Account Balances

($ Billion)

Year	W. Hemisphere LDCs	All LDCs
1978	-19.0	-31.7
1980	-29.5	-38.5
1982	-41.1	-62.3
1985	- 4.8	- 5.2

The United States has felt the repercussions of the LDC debt crisis in our trade account. With regard to the key debtor countries recently identified under the U.S. debt initiative, the United States has experienced a 32% decline in exports and a 13% increase in imports since 1981, and a trade deficit which has grown form $3.3 billion in 1981 to $21.3 billion in 1985. In 1981 nearly 17% of total U.S. exports were shipped to these

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countries; by 1985 the figure had dropped to 12.6%. These countries are listed in the table in the back of my testimony.

This table places some values on the effects of the debt crisis I have described. Current account deficits have dropped significantly for most of these countries. Brazil went from a nearly SDR 10 billion deficit on current account in 1981 to a small surplus in 1984. Chile reduced its deficit from SDR 4 billion to SDR 2 billion while Mexico moved from an SDR 11.9 billion deficit to a surplus of SDR 3.8 in 1984.

Economic growth also declined. Growth rates in 1985 were down relative to the 1978-81 average for every one of the fourteen countries for whom data was available. The unweighted average of the growth rates of these countries fell from an average of 3.4% in 1978-81 to 1.1 percent in 1985.

Because these are countries with rapid population growth, the implications of slow growth are particularly severe. For example, on a per capita basis, gross domestic product rose by 8% in the industrial countries from 1980 to 1985. It declined by 7% for the developing countries of the Western Hemisphere, and by 11% for the developing countries of Africa. For the 14 high-debt countries in the end table for whom data are available, gross domestic product per capita in 1985 was 12 percent below the level in 1980 on an unweighted average basis. In sharp contrast,

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the developing countries of the Far East which have generally followed a more market oriented approach to development and few of whom have problems managing external debt, saw their per capita incomes rise by 21%.

Turning again to the major debtors, we see that their external financial positions remain precarious. Total external public debt for the group has risen from $331 billion in 1981 to $427 billion in in 1985. The unweighted average of the interest payments to export earning ratios has risen from 21% to 28% for the group. For Chile the interest payments to export ratio was 44% in 1985 and for Argentina it was 53%

Need for New Direction in LDC Payments Adjustment

From a trade perspective, at least three aspects of the process of LDC adjustment to date have been adverse to U.S. and global trade interests. First, a substantial part of the improvement in high-debt LDCs trade and current account improvements have been reflected in weakened U.S. trade and current account balances. Second, a number of developing countries have compounded the distortive policies which act to restrict imports in order to promote exports. Third, the full recovery of world trade and growth will continue to be hampered until policy adjustments permit stronger economic growth in the high-debt LDCs without sacrificing the progress being made to resolve their external

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debt difficulties.

The plan announced by Secretary Baker in Seoul Korea in October presents an opportunity to address these concerns. The U.S. debt initiative is a three part program including, first and foremost, growth-oriented reforms in the major debtors; second, enhanced and more effective World Bank lending in collaboration with the IMF, and; third, increased net lending by commercial banks.

One of the most important aspects of the new initiatives on the LDC debt front is the more active role that would be played by the multilateral development banks to encourage the high-debt LDCs to undertake meaningful reforms including trade and investment liberalization. The greater emphasis on policy-based lending by the multilateral development banks will be an important tool to ensure the necessary growth-oriented policy reforms in the major debtors. The World Bank has ample capacity to increase such lending by about $2 billion per year over the next three years, to be concentrated on the large debtors with credible reform programs.

Policy Linkages Between Trade and Debt

The Congress has already recognized the important linkages between LDC trade regimes and prospects for LDC growth and adjustment in the legislation for the latest IMF quota increase.

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Under the authority of the International Recovery and Financial Stability Act of 1983, the U.S. Trade Representative, in consultation with the Trade Policy Committee, makes determinations and advises the Secretary of the Treasury as to whether a country which is applying for or receiving IMF financial assistance maintains trade and investment measures having a significantly deleterious effect on the international trading system. Such information is used by the Secretary of the Treasury in the instructions he provides to the U.S. Executive Director at the Fund to support Fund emphasis on trade and investment regimes in its adjustment programs and to seek the removal of deleterious practices in a manner consistent with the borrowing country's balance-of-payments adjustment program. The U.S. Executive Director has also encouraged greater emphasis on trade and investment regimes and coordination between IMF and GATT staffs in the context of the annual Article IV country reviews.

The IMF and the multilateral development banks, of course, have different missions. The former provides temporary financial support for balance-of-payments adjustment programs while the latter provide support for economic development. Efforts by the multilateral development banks to encourage liberalization in countries seeking financial assistance is consistent with the development goals of the bank and the trade concerns of the U.S. government. Cooperation among the Executive Branch Agencies on multilateral-development-bank issues is strong. The U.S. Trade

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Representative's Office provides its advice on trade policy aspects of lending by the multilateral development banks as a participant in the interagency Working Group on Multilateral Assistance.

High-Debt LDCs Should Be Encouraged to Liberalize Investment and Intellectual Property Regimes As Well

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The Administration strongly believes that trade and investment barriers must be reduced to stimulate sustained, substantial growth of the world economy. Our efforts to open a new round of multilateral trade negotiations in the GATT are intended to further these objectives.

The road to a new round, however, has not been smooth. One of the main obstacles has been the resistance of a number of major developing countries to a new round in which they might be obliged to liberalize their trade and investment regimes. There remains a great deal of resistance on the part of some developing countries to the notion that more market-oriented economic policies -- including less distorted trade and investment regimes -- make a positive contribution to sustained economic growth.

The new round of multilateral trade negotiations offers the opportunity to extend negotiations beyond the area of trade to trade-related issues of investment and intellectual property protection. Investment restrictions and performance requirements are barriers to direct investment and a source of regular trade friction between the United States and developing countries. The investment environment has become so poor in many developing countries that direct investment flows from developed to developing countries have been greatly reduced in recent years. (See Table 4 which shows the reduction in direct investment as a share of

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total private resources flowing to developing countries.) Our trade relations have been further damaged by the failure of a number of developing countries to provide adequate protection to the intellectual property of U.S. and other foreign nationals. The Congress has recognized the seriousness of such unfair practices by mandating in 1984 that the Administration shall take into account policies affecting foreign investment and the protection of intellectual property rights when considering renewal of the generalized system of preferences for individual developing countries.

Table

Direct Investment as a Share of Total Private Resource Flows From OECD to Developing Countries

(Percent)

1965	1970	1975	1980	1981	1982	1983
60	38	39	24	28	22	18

The Brazilian informatics sector provides a near text book example of the types of distortive policies which both weaken the economic performance of the developing countries as well as create discriminatory, unfair treatment for U.S. exporters, investors and intellectual property owners.

Brazil has adopted a series of policies since the early 1970s to promote the development of an indigenous computer industry.

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Under a "market reserve" system the Brazilian government has set aside a substantial share of the Brazilian market for national firms. The market reserve system not only discriminates against U.S. exporters, but against the subsidiaries of U.S. computer firms long established in Brazil. In addition, investment restrictions further limit new investments or expansion of established facilities in Brazil. Because of its low level of technological development relative to that of the United States, Brazil has not completely restricted U.S. investment. It still allows foreign participation in the mainframe end of the computer market. But, Brazil has saddled new investment with both export performance and local content requirements. Furthermore, copyright protection for computer software is non-existent, a situation which permits the widespread piracy of intellectual property whose rights would be protected in our own country. The situation has become even more critical in recent years as Brazil has extended its definition of products and services covered by its informatics policy to include most everything related to computers and digital technology. The production of minicomputers, microcomputers, robotics, scientific equipment are all reserved for Brazilian companies. In response to this situation, the Administration is currently pursuing a self-initiated unfair trade practices case against Brazil under Section 301 of our trade law.

Brazil's informatics policy is unfortunately all too typical of the policies in a number of LDCs which exacerbate their difficul-

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ties in managing their foreign debt and which hurt all participants in the world trade system. Brazil's informatics industry will remain very inefficient in comparison to our own and in relation to global competition. Its products currently sell for 4 or 5 times more than comparable U.S. products. Brazil is hurt in at least four ways by its informatic policies. First, its trade pattern is distorted. Second, its limited investment resources are misallocated. Third, other Brazilian industries which use informatics equipment and services are made less efficient. And, fourth, at a time when Brazil would benefit from additional foreign direct investment capital, it is restricting the inflow. To the extent that Brazil can be encouraged to modify its current informatics policy, not only will the United States benefit from a reduction in unfair trade practices, but Brazil will remove a handicap to dealing with its current debt problems and to assuring future growth.

World Bank and GATT Cooperation

The new U.S. initiative on debt coupled with the new trade round offer an excellent opportunity for greater cooperation between the World Bank and the GATT. There is an important cooperative relationship that can and should exist between the World Bank and the GATT. It is suggested in the proposed legislation that trade liberalization undertaken in GATT be rewarded by additional appropriate public and private capital. Trade liberalization in

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the GATT contributes to some of the policy reforms that the World Bank and commercial banks seek as a condition for increased lending if only because they foster sustainable growth. However, we should also look at another aspect of this GATT/Bank relationship. The potential exists that, when World Bank programs support trade and investment liberalization measures, such measures can and should be taken into account in the framework of the GATT. This approach has been used productively in the past. For example, during the Tokyo Round, the United States took into account trade liberalization measures under IMF programs as long as those measures were bound in the GATT.

There can be significant benefits to developed and developing countries from such cooperative approaches among the multilateral development banks, IMF and GATT. The World Bank and IMF can help countries take necessary structural reforms including trade and investment liberalization, that will expand economic development and growth. In turn, developing countries will be able to secure access to markets in the developed countries under the GATT framework. This will foster national growth and development.

Encouraging Other Developed Countries to Make a Greater Contribution to LDC Debt Adjustment

In this context, I should mention that we in the trade field are

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already working to encourage a greater contribution from our major industrialized trading partners toward aiding LDC debt adjustment. The United States remains by far the industrial market most open to LDC exports. Exports of manufactures are critical for LDCs both because their prices are less subject to fluctuation than commodities and because expanding manufacturing production is so important to the development process. In 1984 the United States received 62 percent of the all manufactured products shipped by the LDCs to the industrial world. The EC share was only 23 percent and Japan's was a meager 8 percent. This openness of our economy to LDC exports is a function of our more liberal trade policy, irrespective of the overall balance in U.S. trade. In 1981, even when the United States had over a $6 billion surplus on the current account, we still received more than half of LDC manufactured exports to the industrialized world.

We strongly encourage our trade partners to rollback protectionist restrictions against LDC imports. We will continue to do so in a new round of multilateral trade negotiations. Although Japan and our European allies, provide a higher proportion of economic assistance as a share of gross domestic product, their foreign assistance is frequently in the form of commercially motivated tied-aid credits. Such practices serve to further distort world trade flows and are strongly opposed by the U.S. government.

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Importance of GATT Framework

As we press our major trading partners to open markets, we must be careful that negotiations on trade liberalization take place in a multilateral framework and not one restricted to a limited number of countries, such as the G-5 or OECD. Only through a multilateral approach to trade and investment liberalization can export markets expand sufficiently to help remedy the debt problems of developing countries. This process already is underway and, with developing country participation, those trade negotiations will foster an expansion of the world trading system and sustain economic growth and development. The GATT mechanism is preferred over the G-5 and OECD framework because it brings developed and developing countries into a system where trade concessions are legally binding.

Purchase of Oil from Developing Countries

The proposed bill calls for additional purchases of oil by the United States government and other developed countries, especially those with current account surpluses. Aside from the budgetary constraints on the United States government in making such additional purchases, we wonder whether we should focus primarily on increasing developing country oil exports. As I mentioned earlier, our industrial trading partners take much smaller proportional volumes of imports of manufactures from developing

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countries. Japan indeed has a large trade surplus with its non-oil producing trade partners in Asia. We hope that our efforts to liberalize trade barriers in Japan will benefit not only U.S. exports but also developing country exports. In addition, EC restrictions on agricultural exports impair not only U.S. trade but also the trade of Latin American and certain Asian exporters. Thus we should focus our attention on increasing imports by Japan and the EC from the United States and developing countries in categories that range from agreculture to industry.

Conclusion

The Administration then is already directly focusing on many of the issues of concern to the committee in the draft legislation. With respect to the trade aspects of this legislation, we do not believe that legislation is essential now to carry out the objectives that the committee has properly set, i.e., to seek trade liberalization in developing countries. The U.S. debt and trade initiatives to assist both growth and adjustment in the high-debt LDCs, the increased emphasis on growth-oriented reforms, and efforts to obtain a greater contribution from Japan and Europe toward LDC adjustment will receive the firmest support from the U.S. Trade Representative's Office.

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SELECTED INDEBTED DEVELOPING COUNTRIES: U.S. TRADE BALANCES, GLOBAL CURRENT ACCOUNT BALANCES DEBT, GROWTH AND CAPITAL FORMATION

	U.S. Exports ($ Millions)		U.S. Imports ($ Millions)		U.S. Trade Balance ($ Millions)		Per Capita GDP Growth Rate (%)		Current Account Balance (Millions SDRs)		Total Debt ($ Billions)	Interest Payment to Exports Ratio (%)	Gross Fixed Capital Formation (% GDP)	
	1980	1985	1980	1985	1980	1985	1980	1985	1980	1984	1985	1985	1981	1983
Argentina	2,622	717	792	1,167	1830	- 450	-15.1		- 3,675	2,480	50	0.53	18.6	16.6
Bolivia	169	118	189	101	20	17	-30.0		- 91	176	4	0.36	11.4	17.0
Brazil	4,917	3,128	4,000	8,147	337	-5,019	4.2		- 9,829	52	182	0.40	21.2	17.0
Chile	1,352	682	559	857	793	- 175	11.3		- 1,514	2,010	18	0.44	18.6	12.0
Colombia	1,730	1,451	1,326	1,456	404	- 5	1.9		- 132	-1,189	13	0.21	17.7	18.9**
Ecuador	856	590	938	1,976	- 82	-1,386	5.8		- 493	- 241	8	0.25	22.3	18.3**
Ivory Coast	185	70	303	558	-118	488	na		- 1,403	-1,001	6*	0.17	24.2	21.7
Mexico	15,141	13,628	12,774	19,392	2,367	-5,764	- 4.5		- 6,271	3,810	97	0.33	26.6	17.3
Morocco	290	226	41	44	249	182	- 5.5		- 1,091	- 964	13	0.31	21.9	21.9
Nigeria	1,143	652	11,316	3,108	-10,173	-2,456	-25.2		3,942	517	18	0.08	24.6^	27.9^
Peru	1,443	492	1,169	1,152	274	-660	-14.1		47	- 250	13	0.31	20.4	18.3
Philippines	1,987	1,375	1,913	2,334	74	959	-15.7		- 1,470	-1,211	26	0.26	26.0	19.2**
Uruguay	183	64	103	571	80	-507	-16.8		- 565	- 121	5	0.46	15.5	8.6**
Venezuela	4,568	3,159	5,547	6,830	-979	-3,671	-19.2		3,633	4,851	35	0.21	24.5	14.3**
Yugoslavia	755	594	476	601	279	- 7	- 1.5		- 1,779	- 242	19	0.15	31.0	24.7-

* Public debt

** - 1984

\- 1983

^ 1980-1982

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Chairman LUNDINE. I don't know whether the gentleman was aware of the testimony we received yesterday, but if you weren't, you anticipated some of the questions that were suggested in our hearing yesterday.

Mr. BALE. I wasn't aware, but I am glad.

Chairman LUNDINE. Well, all the more to your credit.

Mr. Bereuter

Mr. BEREUTER. Thank you, Mr. Chairman.

Dr. Bale, I will start with you. I think the figures in your testimony that certainly need repeating are the percentage of the industrial products that the United States takes from LDC's versus the European Community's share and the Japanese share, and they are, again, 62 percent of all manufactured products from LDC's flow to the United States, 23 percent of those go to the EC, and, in your word, a meager 8 percent to Japan.

I think those are very important statistics to keep in mind and they give us some idea of the task ahead of us.

As I usually do, I will use some Latin American examples. I have been concerned about trying to help the nation of Uruguay with its difficult situation as they move back to a democratic government and they say, we want trade, not aid.

As the Commerce Department sends trade assistance teams down to help them and as they deal with me, everytime they have an opportunity to export to the United States, they run into quotas. Those quotas are divided up among European nations as well.

They run into the Italians in several areas. They run into a quota that we have provided in cheese for the Danes. There are two ways of providing an opportunity for greater LDC products to be traded. One is for the Europeans and the Japanese to open their market. Another is for us to redistribute the quotas that we have on some of our products. If we can't eliminate them, at least we can redistribute.

But there is no interest in doing that in the administration that I have been able to see.

I hope that perhaps you can give that some attention. I was particularly pleased also that you brought up the matter of the agricultural subsidies and production of some of the logical opportunities for LDC's. The biggest one of all, of course, is the EC. I would be very happy if the EC simply stopped devastating the Caribbean with their sugar. That would be a major contribution.

As you may know, they are producing sugar beets at an unprecedented level and occasionally, they simply devastate and one and two-export nations in the Caribbean.

They have moved from a net importer in eggs and poultry to the world's largest exporter. They have taken markets away from the Brazilians and the Americans, but especially the Brazilians, in North Africa, the Middle East, in Japan. The level of production in the EC is not only very costly to our treasury, but it has dramatic effects upon lesser developed countries.

I hope we keep that on the agenda at GATT and other places.

A question for you. I believe that we have recently concluded, or are about to conclude, some kind of a pact, some kind of a treaty with Mexico. Mexico is not a member of GATT, unfortunately. I

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gather their interest is peaking at this point. Hopefully, they will join GATT. But what kind of advantages have we recently given Mexico which ordinarily would accrue only to GATT signatories?

Mr. BALE. Well, Mr. Congressman, it is true, we are in negotiations through the GATT with Mexico in the form of its accession to GATT.

Concessions that we have made to the Mexicans that normally would flow to GATT members relate only to an agreement that we have bilaterally with Mexico in the subsidies field. This goes back a year or so to an agreement which was concluded between our agency and the relevant Mexican officials that also provided for reduction in Mexican subsidies.

That agreement provides benefits to both sides. Normally, in the GATT, members agree to the kinds of codes that are negotiated there, but Mexico was not a member of the GATT at the time, and the effort that we made to resolve the GATT accession of Mexico 6 or 7 years ago was not successful. So, in the meantime, we have had to deal with the issue on a bilateral basis.

So that problem we think will be resolved so long as we successfully conclude an accession negotiation with the Mexicans.

Mr. BEREUTER. I asked yesterday in a hearing with Secretary Baldrige what the STR's authority for negotiating that agreement was. I am satisfied you do have the authority to negotiate it.

I hope that you are not relieving Mexico's interest in joining GATT by this bilateral arrangement.

Mr. BALE. Certainly not. I think the Mexicans and we perceive that there is a lot more to be gained through that process.

Mr. BEREUTER. I want to suggest to Secretary Mulford a missing element in the debt reduction strategy, but I'll have to wait for my second round on that.

Chairman LUNDINE. I appreciate the gentleman's forebearance.

Mr. Torres, I am going to ask that we stick to the 5-minute rule, just because of the possibility of a vote. And I assure the members that there will be another opportunity. But if you could abide by that, I would appreciate it.

Mr. Torres.

Mr. TORRES. Indeed, I will, Mr. Chairman. I will be very brief.

I would like to pose two questions, mainly for Mr. Mulford. You mentioned in passing the question of our three largest debtor nations in the hemisphere—Argentina, Brazil, and Mexico.

Would you just briefly, again, because we are under this 5-minute time limit, could you briefly explain how the numbers work out for Mexico?

You mentioned that interest rate declines at least partially offset the decline in oil revenues. But isn't it true, then, that this offset is by no means equal, or in other words, that Mexico is facing an export earnings gap relative to the debt service requirements?

Mr. MULFORD. It is true that the decline in the price of oil presents to Mexico a problem with regard to its foreign financing requirement in that it is somewhat bigger than it otherwise would have been.

We have been discussing that with the Mexicans and I think it wouldn't be productive here to try to actually outline numbers to you. But you are right, that the sharp decline in oil prices in gener-

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al that has been suffered by Mexico produces a reduction in their revenues greater than the advantage they get from the reduction in interest rates that's taking place up until now.

That doesn't mean there aren't other benefits that will flow to Mexico over time. For example, the benefits of higher growth in the developed world markets produced by falling oil prices which spells higher exports, for Mexico, which, of course, come later. It takes time. But there is an offset there.

In other words, the news from Mexico isn't all bad. That's the basic point.

Mr. TORRES. Thank you. On pages 4 and 5 of your testimony, you cited as part of the structural reform, and it was just skimmed over, the issue of flight capital.

In this kind of situation, would you support negotiations to achieve a multilateral agreement on loosening bank secrecy laws to achieve better oversight of large flight capital accounts?

We hear today, obviously this is very timely, the cases of Marcos, Duvalier, of the President of Zaire come to mind, who, as mere individuals, are almost solely responsible for the flight capital problems of their respective countries.

Mr. MULFORD. Well, I don't think that that last comment is exactly correct. They may be responsible for large numbers. But I think we should distinguish between actions of certain individuals who at one time were heads of state and the functioning of markets where many, many people in these markets are engaged in moving their capital offshore.

I don't think the solution to the problem of flight capital in general in the markets is to reduce bank secrecy and negotiate a multi-lateral agreement or anything of that sort.

I think the answers to reversing flight capital or, in fact, containing it have to do more with the general kinds of policies that are followed in the debtor countries—realistic exchange rate policies, positive interest rate, a friendly environment toward local investment with incentives for people to invest locally, and things of that sort which will do more, in my opinion, to keep capital at home than negotiating international agreements. I think it's impractical to attack the problem that way.

Mr. TORRES. You don't see that as a deterrent to capital flight at all?

Mr. MULFORD. Don't see——

Mr. TORRES. Well, the bank secrecy laws, loosening those up. I was in Argentina not too long ago and talked to the Argentine President, who was very much concerned about capital flight from Argentina. I said, how do you stem this? How do you begin to put a damper on this? He said, it's impossible, without access to who sends their money to what banks in what countries.

Mr. MULFORD. Well, that is never been a very effective means of affecting financial flows.

For example, people would get around that by under-invoicing in trade transactions. In many cases, removing capital is not illegal and people do it legally because they think there's a better investment opportunity offshore because their home government is providing the wrong sort of environment for local investment.

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As I said before, I think that the real solution to this problem is a market solution and it has to do with the kinds of general policies that apply in these countries, much more than restrictive foreign exchange controls or agreements that would delve into whose money goes to which banks and so on.

That may be appropriate for certain cases that have to do with heads of state or something of that sort. And it may be helpful to certain problems that come up in the drug business and so on. I am not saying there's no role for that.

But I think, in general, flight capital is an economic problem that is more effectively addressed by policy changes in the countries.

Mr. TORRES. Thank you, Mr. Chairman. I yield back the balance of my time, if I have any left.

Chairman LUNDINE. I don't think you have any, but thank you for being attentive to what I'm trying to achieve.

Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

Mr. Secretary, you made some excellent points regarding the need to growth-oriented reform in your presentation to us.

In view of some of the reluctance on the part of these nations to subscribe to points of the Baker plan that are oriented that way, how do we go about accomplishing this?

Mr. MULFORD. Well, I'll try to give you a short answer in view of the time constraints here. But I think that, indeed, what we have to look at is what is actually happening in the case of certain countries and not so much what——

Mr. MCCANDLESS. Could we narrow the——

Mr. MULFORD [continuing]. And not so much at what they say.

Mr. MCCANDLESS. Let's take Mexico, then, as an example, if you want to use it. Or if you want to use general terms——

Mr. MULFORD. Let's take Argentina and Brazil.

Mr. MCCANDLESS. All right. [Laughter.]

Mr. MULFORD. Well, we can take Mexico as well.

Mr. MCCANDLESS. Well, let's take Argentina and Brazil.

Mr. MULFORD. But in Argentina's case, for example, I don't think you're going to see these countries come forward and formally embrace or sign up for the United States debt initiative because I think that's a politically sensitive thing for them to do in their own economies.

But I think what you have to look at is what kind of changes they are making. And as I said in my remarks, Argentina has announced a number of changes in privatization of companies, opening up exploration for oil on an easier basis to foreign firms.

The Brazilians have made a major watershed decision to deindex their economy. That's something that is a major decision.

I think that is evidence that the kinds of things that are advocated in the plan are being grasped and put into practice by the various countries.

Also, there's a very substantial increase in negotiations between countries and the World Bank to try to enhance flows of funds. This is further evidence that they're taking the thing seriously and trying to utilize the resources.

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Mr. McCANDLESS. The other question I had for you is are you, in your position, in your role, satisfied with the coordination, the relationship between the various international institutions, and are they headed in the right direction collectively and coordinating this World Bank, Development Bank, et cetera?

Mr. MULFORD. I think that we are not satisfied with the degree of coordination, but I don't mean that critically. I think that there is a willingness on the part of the Fund and the Bank, for example, to coordinate more closely.

But it is going to take time and concrete cases to work out exactly how that coordination fits together.

We think there's a long way to go there, a lot to do, but we believe they are aware of the problem. As the major debtors come forward for renegotiation of their debt and new IMF programs—for example, Mexico, Argentina—there will be an opportunity for the Fund and the Bank to put into practice a closer coordination of their activities. And we are looking for important improvements there.

Chairman LUNDINE. Would the gentleman yield briefly?

Mr. McCANDLESS. Who should the catalyst be in this process?

Mr. MULFORD. Well, I think that we certainly will push both organizations. But as I said, they have been receptive and I think what will really bring them together is that the private commercial bank flows that used to take place when the IMF agreed to a program, and before the World Bank loans came into play, will now only flow when the two organizations have done their coordination and proved that the policy changes taking place warrant the commercial banks putting up the money.

So I think the commercial banks are going to be a pressure in bringing closer coordination.

Mr. McCANDLESS. Thank you, Mr. Secretary.

Chairman LUNDINE. Would the gentleman yield?

Mr. McCANDLESS. Certainly.

Chairman LUNDINE. On that point, some people would say that there's a fundamental difference between IMF programs and what you are, we are, asking the World Bank to do, that IMF means austerity, it means trade restrictions on imports, and it is not oriented to growth. And that what we are talking to the World Bank about, whether they've achieved it or not, is a program to emphasize growth.

To what extent do you think that's a valid analysis? And if so, how can they cooperate if they're two vastly different philosophical bases?

Mr. MULFORD. Well, there are differences. The IMF is not a development institution. It is a balance of payments financing institution that operates on a revolving fund type of basis.

Its main mission is to provide standby programs to stabilize a serious balance of payments problem. That involves, in some cases, certain elements of austerity in order to contain the situation because you have got to establish a stabilized situation.

The World Bank programs in the sectoral and structural adjustment areas are designed to get at the longer term structural changes needed for longer term development and a restoration of economic growth. Therefore, their focus is different and their

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method is different and they are not engaged to the same extent in a short-term stabilization exercise.

Therefore, it is true that the World Bank has a greater preoccupation with growth than does, in the initial instance, the Fund. But the Fund has not been insensitive to the need for growth and I think is wrongly accused of dishing out a steady diet of austerity.

Now I think it's very important as we look to the future to recognize that if we are going to get credible reform in these countries, we have to be sure that the reforms are working. That means that you have got to get a closer liaison of some kind, not necessarily a merging or too close a relationship. You want to keep the identities of the two institutions.

But you've got to get a closer working relationship in place because if you just start with another IMF program to stabilize the balance of payments, the commercial banks and other private lenders are going to say: "Wait a minute. We have been through this before. It didn't work last time because there wasn't genuine internal reform and strong enough growth established. We are not going to put more money up if it's just going to flow out in the form of capital flight. We have got to see what sort of longer term reforms are going to be implemented by the World Bank."

So they are going to be more cautious and therefore, there is a need for the IMF and the World Bank to work more closely together in order to ensure a greater credibility in the reforms that are being implemented by the countries.

So I think it's absolutely necessary that they work more closely together.

Chairman LUNDINE. Does the gentleman want to ask any other questions?

Mr. MCCANDLESS. No.

Chairman LUNDINE. Thank you.

Mr. MCCANDLESS. Respecting the 5-minute rule.

Chairman LUNDINE. No, I didn't want to take part of your 5 minutes. That is all.

The idea of policy reform being a condition and the idea that the World Bank will be a coordinator in the sense that the Secretary just mentioned, and provide additional structural adjustment lending, is a whole new approach to international development. Why shouldn't this fundamental U.S. policy be established in law?

Mr. MULFORD. Well, I think that that fundamental policy is already established in the organizations. In other words, in the World Bank, there has been growth over the past few years of what we call policy-linked lending. And what the debt strategy calls for is an enhancement of that kind of lending. Not an origination of it, because it is already being done by the World Bank, although on a fairly limited scale.

Therefore, I don't really think legislation is required because it's a question of making a stronger policy request and influencing the World Bank to increase this type of lending and recognizing that the World Bank, as it does so, has itself to feel its way along, learn how to do it effectively if it's going to simultaneously increase this kind of lending and maintain its creditworthiness as an institution.

Chairman LUNDINE. The gentleman from California I think asked a key question and I would like to follow up on that as well.

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This idea of the reform of LDC policies, which both of you mentioned, and I think there is bipartisan enthusiasm for the idea that the developing countries ought to adopt strategies that are more open, more growth-oriented, more market discipline to them. But if the steps 2 and 3 of the Baker initiative are dependent on that first step taking place, the question is who decides that? Who is the catalyst here?

It's very vague, and my understanding of this, who makes the determination that country *x* has in fact adopted sufficient policy reform so that it triggers not only additional commercial bank lending, but all the public resources that we are able to bring to bear on their problems.

Mr. MULFORD. Well, I think it's very clear that what will happen if you take a country that is requiring the full treatment, as it were, of the initiative—it needs an IMF program, new bank money, et cetera—it will negotiate in most cases a standby program with the IMF. And simultaneously, it will be negotiating a variety of sectoral loans with the World Bank and those sectoral loans will be for the sectors that need reform most urgently. And there will be in those sectoral loans conditions that have to be met before the loans can be disbursed.

And those conditions will be the sort of things that are unlike the IMF's, which are short term in nature and easy to measure. They will be longer term in nature, harder to measure the results of, but more fundamental in their impact on the internal economy of the country.

Behind the two organizations the private credit markets will be watching this process. And they will make a judgment at some point that the IMF program is adequate, the sectoral loans that are being put together are going to result in major structural reforms, and therefore, they can go ahead with the new lending that is required on their part.

Now this is a very delicate exercise. It will take time for this to fall into place. You can't see great announced events taking place the whole time in this process, as some members of the media would like to see.

It's a long, drawn out process with many small pieces that need to be negotiated and fall into place.

But eventually, these programs, in the case of the large debtors, will produce a new round of resources and hopefully, this time, those resources will be more effectively employed in the development process in those countries than has been the case hitherto, where there has been substantial capital flight, ineffective follow-through on the part of the countries, and often, insufficient resources coming with sufficient conditionality from the World Bank.

Chairman LUNDINE. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Secretary Mulford, maybe it's my service on the Foreign Affairs Committee that prompts me to say this, but it seems to me that the role of bilateral assistance in this overall debt adjustment initiative hasn't been given enough emphasis, or isn't an element or is neglected.

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My concern, as we move to debtor policy adjustment, that you created a whole new category of countries that have stress coming out of those kinds of adjustments.

It is unfair, I realize, to suggest that IMF is austerity-oriented and you gave a good statement on the relationship between the World Bank, the other MDB's and the IMF just a minute ago that we will have to re-emphasize from time to time on the floor, I think.

It seems to me, though, again using Latin America as an example, many new democratic regimes in their first several years, the kind of stress on their citizens of making these adjustments, the unemployment changes that are likely to be found in initial stages, means there's going to be a lot of stress there.

It seems to me that our bilateral aid programs ought to accommodate that. Congress has spoken on a bipartisan basis indicating that there's going to be no increase overall in foreign aid during fiscal year 1987.

A country like Ecuador, for example, it may well be important for the administration, State, AID to go to the Foreign Operations Subcommittee and to suggest that this country, because of structural reforms that we are encouraging there, deserves to have a significant share of not only ESF, but I would also think perhaps we ought to provide more food assistance, medical assistance, where we do not dislocate domestic producers in the case of agriculture, as an assist, as something of a safety net.

You will recall the situation we had in the Dominican Republic not too long ago when changes in policy resulted in riots. I am concerned that we not destabilize these fledgling democratic initiatives by our debt adjustment strategy.

I think, unless we carefully provide the right kind of bilateral assistance in the right amounts, we might.

Do you have any reaction to my suggestion that we ought to have—a major component in this is really a coordinated effort to use our bilateral assistance to provide a safety net?

Mr. MULFORD. Well, I agree with your principle, but I think that there's one point that needs to be made to clarify that just a bit, and that is that among the major debtors where the initiative is directed, the 15 major debtors, most of the really large debtors are not substantial recipients of foreign aid. They're not economies that are highly dependent on foreign aid or even official credit, in many cases. And therefore, that question is not so relevant for them. But it is relevant——

Mr. BEREUTER. It is quite relevant, for example——

Mr. MULFORD. Sorry?

Mr. BEREUTER. It is, for example, in Ecuador, which unfortunately has a very high debt given its GNP.

Mr. MULFORD. Yes, it is. But there are some of the smaller countries, Ecuador is one, where it's relevant. But I would suggest it becomes particularly relevant when you move into the smaller debtors where the mix of credit and resources is less toward the private sector markets and more toward official government credit, aid, and so on.

There, it's very, very important and I think the fact is that we have been supportive of both bilateral aid flows as well as multilat-

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eral resources. But there's an increasing budgetary stringency here that is going to be a problem in keeping these flows of the magnitude that people would like to see.

Mr. BEREUTER. I appreciate your comment and I think it's accurate. I simply want to stress that I think there will be stress as a result of these policy and debt adjustments and we, where appropriate, ought to be there to give priority to those nations that need assistance if, in fact, they qualify for foreign assistance.

Thank you, Mr. Chairman.

Chairman LUNDINE. We are going to take a recess now of about 10 minutes. We will return and I assure the witnesses that the rest of the questions and answers will be no more than a half hour in duration.

[Recess.]

Chairman LUNDINE. During the series of hearings that we have held on this proposed legislation and, indeed, last year, the subcommittee has heard what I would describe as a tale of two cities.

One is comprised of bankers who have said that with the goal of getting their debt serviced by the LDC's, the bankers claim that this problem will work its way through and we don't need to take much bolder action.

The other is comprised of people in the developing world who have often experienced a declining standard of living and unemployed Americans who have lost their jobs because American firms can no longer export to the developing world.

Now both of you come today and say that there's no need for congressional action, that the problem is essentially working itself out. Trust us, you say, that you and the banks will work it out.

The question I have is is a liberalization of trade restrictions by the LDC's a precondition to debt relief under the Baker initiative, and if so, what are you really trying to do about it?

Is this going to be a top priority item at the Economic Summit in Tokyo? What a wonderful opportunity for our President to go there and tell them they're not doing their fair share with respect to the issue of imports, not only from the United States, but from the developing countries as well.

I would like both of you to respond, but Mr. Bale, why don't you go first?

Mr. BALE. Well, perhaps I will give Assistant Secretary Mulford a rest here for the moment.

I think in his comments, Secretary Mulford referred to a certain degree of simultaneity, if I can call it that, between the liberalization and lending aspect of this program. In the context of the sector and structural adjustment negotiations over large loans, including those involving Mexico and Colombia and others, there are discussions about trade liberalization. The question is how important are those? I think the answer is that they're very important. They're very important, at a minimum, from the point of view of the efficient use of the financial and economic resources of the country involved.

It's an important issue also from the point of view of the administration. In the 1983 IMF quota increase bill, the Congress recognized it, and the administration has been following through upon an exchange of views between the Treasury Department and the

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U.S. Trade Representative about the kinds of trade and investment restrictions that should be addressed by the Fund in its own negotiations with borrowing countries.

The enhancement of the link between trade liberalization and the lending policies of the Bank with regard to the summit are concerned will be taken up in certain discussions leading up to the summit.

That is to say we would like our other developed trade country partners to recognize the contribution that the Bank is making to trade liberalization through its sector and structural adjustment lending by taking these liberalization issues into account in various GATT-negotiations. These could be GATT accession negotiations. These also could be in the new round of negotiations.

Now, whether you can, through the World Bank, get into a posture of making trade liberalization specifically a condition for bank lending raises other issues. For example, the discussion earlier was about Brazil and the positive things that they are doing. In certain sectors, such as the Brazilian informatics policy, the microelectronics sector which I discussed earlier, they are not doing very good things. They are restricting trade. They are restricting investment. And they are restricting technological development.

Now, is a change in that practice a necessary condition for the Bank to increase bank lending and credits? That's a real problematic issue, and so, that raises the question in legislation whether one can address a problem in black and white that has to be looked at and balanced out in the particular situation that arises.

But I think the point that you raised concerning the importance that should be given to trade liberalization and other forms of liberalization, investment as well, that relate to bank lending also gets to the point of the role of the market place that Secretary Mulford raised, which is: What will banks do themselves in the light of policy practices and the political processes that lie behind them and the confidence that is either there or not there that will provide the correct conditions for additional commercial bank lending.

So this is another facet of the linkage between lending and trade liberalization.

Chairman LUNDINE. Let me ask one followup question to you and then turn to Secretary Mulford.

I will give you a little background. Last summer, I guess it was--it was prior to the Group of Five meeting in September, at any rate—some Japanese Members of the Diet were here, pretty substantial legislators from Japan. We had a private meeting and they asked us, what do you want us to do? A couple of us said, one, two, three, four. No. 1 is the yen-dollar relationship. That's absolutely imperative.

They kind of looked amazed, like we have never been asked, in a sense. That may not have been accurate, but that was their claim.

With respect to the Japanese in particular, and given the fact that they're going to get the biggest dividend of any country, perhaps, from falling oil prices, have we specifically asked them—you're our negotiator—have we asked them, open up your country to more exports from LDC countries, imports into Japan? We

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really care about this. You ought to do it, in clear, words of one syllable.

Have we asked that?

Mr. BALE. We have asked them, Mr. Congressman, to open up their economy to imports from all sources. We have urged them, both at sectoral level discussions and in general level discussions, to develop an import vision in Japan which parallels the export conscientiousness which they have.

Certainly, the Japanese location in Asia and its linkages—many linkages to its investment flows—they've invested some $50 billion or more in developing countries, opening up the possibility of diverting more of the trade of developing countries to Japan.

But I think we have to approach that in a multilateral context again. We have a strong interest in the Japanese market. We believe that the efforts that we make to break down the barriers to Japanese imports of such products as leather, for example, not only benefit United States exports of those products, but also developing country exports of those products.

It's a little bit difficult for us just to single out developing country exports, but, rather, to approach it in a more general sense.

The problem in Japan is imports, in general, that they are not growing in proportion to the economy, that residual trade barriers remain, and that those trade barriers have severe impacts on developing countries and ourselves.

Chairman LUNDINE. Secretary Mulford, let me just ask you a more specific question and then I would welcome your observations on my general problem.

Taking my comment about the two cities, isn't it true that we have really put a higher priority on these countries paying interest on their debt than we have on trade liberalization?

Mr. MULFORD. I would say no. In the case of the debtor countries, for a long time now we have had a consistent position in the World Bank and other MDB's to advance trade liberalization and to, in fact, in cases where it's compromised, vote against loans that appear to be moving in the wrong direction.

So I think the track record there is clear. It relates mainly to sectoral and structural adjustment lending and lending for industrial projects that are flowing out of these institutions. But where those questions have come up, we have attempted to pursue a consistent policy of advocating trade liberalization. At the working level, I think that's the answer to that question.

You raised another question a minute ago about have we asked developed countries to open their markets?

The answer to that, at least from my perspective, is that in a number of fora, using exactly the figures that have been cited here, I have asked these countries to open their markets. And I have also pointed out that when Japan takes only 8 percent of the manufacturing exports of developing countries, the remainder of what it doesn't take is reflected back into our market, which is an open market, and further complicates our problem.

So it isn't just a question of access to Japan; it's the reflective power that is created by their market closure. And I think it's a very important issue and that those countries should take heed of

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these figures and do their part to open their markets to the products of developing countries.

That goes for the EC as well.

Chairman LUNDINE. With regard to MIGA, Mr. Bereuter raised an issue, in a sense, in his opening comment and I wonder, I would be interested in your response.

I think there's general support for the concept of a guarantee agency. You know, you have lectured me a little bit about Gramm-Rudman and budget problems and I think you know the difficulty we face, and that is trying to figure out how to be good advocates for many of the programs and policies that you have followed.

But it's tough to ask for new money for a new agency. Frankly, we are going to have to take it from existing agencies. And that apparently troubles the Republican caucus and I don't think it would be exclusive to the Republicans.

Can you comment? Where is this money going to come from?

Mr. MULFORD. Well, I recognize that it poses a money problem, although the money involved is only $22 million. It's not really a big ticket item.

That doesn't mean to say that I am unaware of the fact that it takes a lot of small items to make up large numbers.

But I do think we should bear its relatively small size in mind. I think we should also bear in mind the fact that in the debt strategy and in the need to solve the debt problem, a fundamental part of that strategy is that there should be encouragement to the debtor countries for growth purposes, to open their markets to direct investment more fully.

Because we hear a lot about austerity being dictated by the IMF, debt service requirements being burdensome to these countries and that they can't get growth going and so on. I think it's important to emphasize that the decision for growth in these countries rests in large part in their hands. Not all policy changes involve austerity. A willingness to open their markets to direct investment, for example, is an option that involves growth, job creation. We know that. We have seen that time and time and again around the world.

Therefore, the MIGA, although it is small, and I don't think we should expect too much from it, is a very, very important symbol of that need and in our view, will help advance in a very real way direct investment flows to these countries.

That is why we believe that we should not wait. I'm aware that it's a difficult problem from a funding standpoint, but I am very unhappy to hear that we are going to have to wait until 1988 because I think we want to be a leader in this field and we want to see ourselves pushing in any way we can to get better direct investment flows going because direct investment flows are one option to additional debt that is productive and is cheaper than borrowing more money. And there aren't very many options available to these countries.

So we really must press. If they want to grow, they must elect to open their markets to greater direct investment flows. And MIGA is a very, very important because it sets the stage for that. It contributes to it in a number of different ways.

I think we should be very supportive of it.

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Chairman LUNDINE. Isn't your proposal to end all Government support for the Overseas Private Investment Corporation directly contradictory to everything you just said?

Mr. MULFORD. No, I don't think it is, although I'm not aware that a decision has been made.

Chairman LUNDINE. It's in the President's budget.

Mr. MULFORD. Well, I think it's still to be worked out. But I think the answer is that if that change were made, it would not alter the role of OPIC. It would continue to do the business. It's not as if it would disappear.

Chairman LUNDINE. Finally, Secretary Mulford, I would like to ask you about your comments about the World Bank gearing ratio. I would like to tell you that before proposing legislation in this area, I gave serious thought to the problem you have; that is, worsening markets and affecting adversely the very thing you want to help by even talking about it.

And therefore, I am entirely sympathetic that if we do something to reduce the quality of World Bank bonds, we not only probably raise the interest rate by several tens of basis points, but also maybe contract the amount of capital that's available for them to borrow.

But the question I have, then, the tradeoff is that you are then going to have to go for a general capital increase. If we really expect a major additional lending function to be undertaken by the World Bank, will Treasury be prepared this year to come in with a 5- or 6-year projection of what we need in terms of a general capital increase?

Mr. MULFORD. Well, I made a statement in my testimony on the general capital increase which I think is clear. But I think it's very important to understand that the first priority in the debt strategy is to see reform in the debtor countries and to see the rest of the parts of the debt strategy begin to work—commercial bank flows beginning, World Bank flows beginning, and credible reform taking place.

As I said before, if that process does not get started, then there will not be a success in these countries. If it does get started, we believe that there are adequate resources today in the banks, in the World Bank, to see this process begun in a very fundamental and a very comprehensive way within the next 2 to 3 years.

That is the message of the debt strategy, and that there are adequate resources in the World Bank for that purpose.

We need to see as strong an incentive as possible for countries to make the necessary reforms and for the banks to come forward to lend.

In my opinion, if you come out now and announce a massive capital increase just because it makes you feel more comfortable, admitting you don't need the money right now or over the next 3 years—in other words, just to do it to say that it's there down the road—you are removing an important incentive by saying to everybody, don't worry, there's all kinds of resources and it's going to flow to you and so on.

There is no point in that approach, in my opinion, as a strategy. The strategy is to get effective change and progress and to finance that, we have the resources. Then, the plan moves forward and the

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pieces fall into place, we will support additional capital as required for the World Bank.

It couldn't be more clear. It couldn't be more consistent. And, in my opinion, it couldn't be more geared to insuring that we see the kind of performance in all the elements of the strategy that are required.

So I don't see the need for being as forthcoming in the sense that you've suggested.

Chairman LUNDINE. Well, without prolonging this at the present time, I might just say to you that I have grave reservations about your strategy. I, for one, am going to look very critically at other proposals the administration has until you are forthcoming about the resources to carry out an initiative that I support.

Mr. MULFORD. But the resources are there. They are adequate right now, for the next 2 to 3 years. That's been clearly identified.

Chairman LUNDINE. That's your opinion.

Will the administration use the interim and development committee meetings in April and the summit in May to try to establish the link between debt and trade?

Mr. BALE. I will say one thing about that. We certainly will press at the summit to give further impetus to our new round of trade negotiations. I mentioned the earlier reference to the effort by the administration to get our trade partners to recognize the trade liberalizing efforts of the World Bank.

So those are at least two initiatives that we will pursue with regard to trade. There are the overall efforts that the Secretary of Treasury stated and the President will be making, of course with other economic issues that are related.

Chairman LUNDINE. I want to thank both of you—did you want to say something?

Mr. MULFORD. I think the international debt issue will certainly be thoroughly discussed at the spring meetings of the interim and development committee meetings and I have no doubt it will also be present in the summit discussions.

Chairman LUNDINE. The question is, Will trade liberalization be linked to that in the U.S. discussion?

Mr. BALE. Well, there is certainly the element of discussion and resolution. Undoubtedly, the OECD ministerial, for example, which is another part of this element, as well as the interim and development committees, will address the need on the part of developed country nations to maintain open markets for LDC exports.

I think, increasingly, the development committee, in particular, which I have attended as a delegate with the Treasury Department, has been making strenuous efforts to make sure that the Japanese and the Europeans also recognize their obligations as a financial issue to maintain open markets in the trade field.

The U.S. Trade Representative is not the lead player in the meetings of development committee and interim committee. But what we have seen and what my contributions to it have been, are very much appreciated, I think, by the Treasury. They have already anticipated many of the same issues, specifically that you cannot maintain economic growth and development without those open markets.

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If I could add, Congressman Bereuter mentioned the problem of sugar and a couple other barriers in the United States, as well, to LDC exports. I don't think we should ignore the problems that we have in working together between the Congress and the administration.

I mentioned in my testimony, we are relatively open and the data show it. But we still have issues that come along such as sugar quotas and textile quotas and the manufacturing clause that constantly provide barriers to LDC exports. We've just got to make sure that we are doing our part and our maximum effort to maintain open markets here, too.

Chairman LUNDINE. Agreed. I want to thank both of you for your testimony. It really is helpful. I think—it's easy to say that we have the same goals. But in this case, we not only have the same goals, but the same approach, I believe, to many of these problems.

Perhaps any differences in where we stand depends a little bit on where you sit. [Laughter.]

But any kind of criticism that has been implied from the Chair or I think from this side probably does depend on our perspective based on where we sit.

I appreciate, incidentally, all of your constructive criticism about the ideas that were proposed in the draft. We did that draft so that we would get constructive, as well as skeptical, comments.

Thank you very much.

Mr. MULFORD. Thank you very much, Mr. Chairman.

Chairman LUNDINE. I want to make an announcement. I'm sorry. Just one moment.

The subcommittee will be convening on April 10, 1 or 2 days after the return from the congressional recess, to consider whether any legislation will be adopted by the subcommittee or recommended by the subcommittee.

[Whereupon, at 11:45 a.m., the subcommittee recessed, to reconvene subject to the call of the Chair.]

[The following statement with attached paper of Pedro-Pablo Kuczynski was received by the subcommittee for inclusion in the record:]

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Statement by Pedro-Pablo Kuczynski

I am Pedro-Pablo Kuczynski, Co-Chairman of the international group at The First Boston Corporation, an international investment bank based in New York. My testimony is personal and is not meant in any way to convey the views of my employer.

I commend the initiative of Congressman Lundine and his colleagues on the subcommittee on International Development Institutions. The debt problem of developing countries, which is centered in several major countries of Latin America plus the Philippines, Nigeria and a few other countries, has by now festered for several years. While much progress has been made, it is also true that economic growth has plummeted and development prospects, partly because of a long-term decline of commodity prices, are uncertain at best. While the multilateral development institutions cannot by themselves be expected to solve any of these problems, they are an important part of any concerted attack on them. As background on the economic context, I attach a recent unpublished paper on development prospects in Latin America and elsewhere.

As regards the proposed legislation, it may be useful to distinguish between what can be achieved in the short term, let us say the next year or two, and what will produce results in the longer term, although preparatory steps would have to begin now. Among the former are to accelerate loan disbursements for already approved and committed loans from the MDBs (section 201 of the draft legislation) while the latter include increasing the capital of the World Bank and other MDBs (section 204) and

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trade and investment liberalization in developing countries (sections 301-302). Increasing cofinancing (section 401) and structural adjustment lending (section 202) are in an intermediate position: they can be accelerated now, but results will take time.

The proposed legislation is properly persuasive rather than mandatory, since it is not administratively easy to implement.

I will form my remaining comments on the subject of accelerating loan disbursements and on the "gearing ratio" of the World Bank and the other MDBs.

I would make the following comments on the proposal for more rapid disbursements from the MDBs to the highly indebted countries, which I strongly support in principle:

a) It should be seen as a temporary measure only, to last for a year or at most two, while the MDBs work up new forms of structural lending. A new President of the World Bank, however, well prepared, will also take time to arrange his priorities.

b) Disbursements of 100 per cent, even for a year or two, seems too high: some effort on the part of the recipient countries in providing a modest level of counterpart funds is necessary.

c) Countries that receive an "accelerated disbursement program" should respond by providing the World Bank and the other MDBs with a clear plan of action on structural improvement, including fiscal reforms, trade liberalization, privatization, and the other elements of reform necessary for successful development.

The MDBs, especially the World Bank, have the resources for a short-term program of accelerated disbursements. The projects are there --

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they have already been appraised and approved -- and so are the resources. However, as the proposed legislation clearly recognizes, there will be a need for additional callable capital of the MDBs if their lending is to continue to expand and they undertake new responsibilities towards the debtor countries. In that connection, I respectfully differ from my good friend William Cline on his proposal to increase the "gearing ratio" of the World Bank:

i. First, this is not a legislative matter but rather a matter of financial practice. The Bank has not borrowed more than the combined callable capital of its triple-A rated members (basically the OECD countries) plus the paid-in cash capital and accumulated reserves. The strong financial backing of the Bank and its sound financial administration -- with no defaults over its 40-year history of lending -- are what commends it to bondholders and give it a top credit rating.

ii. To tinker with the "gearing ratio" could induce investors to look at the immediate economic prospects of some of the major borrowing countries, instead of at the basic financial strength of the Bank itself and its major shareholders, and might then set in train a deterioration of the market view of the institutions, with consequences for borrowing costs that cannot be foreseen. Changing the gearing ratio is like a little bit of sin: once started, it is difficult to stop.

iii. The capital increases which the MDBs require over time are contingent liabilities of their shareholders: the cash portion is

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small, and could be made even smaller. The callable capital tells the capital markets that the governments of the major industrial powers of the world support the MDB's: there is little point, therefore, it seems to me, to water down that commitment.

Vienna, Austria, March 10, 1986.

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Revised Draft

October 14, 1985

Latin America: Is Development Dead?

by Pedro-Pablo Kuczynski*

The prospects are bleak, unless there is a concerted and mutually reinforcing combination of international and domestic action.

Except for the United States and the East Asia and Western Pacific rim, the eighties look like the decade of slow or no growth. Development, in the sense of real income growth for the majority of the population, is stunted by a combination of high external debt and low commodity export prices in many if not most of the countries of Africa and Latin America. The average African today has an income no higher than twenty years ago[1].

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[1] Income rather than output is the key measure of welfare. For example, if I produce and sell peanuts, and my volume of production has risen from one to two tons, my per capita production (a simplification of per capita GDP) would have doubled; but if one ton of peanuts enables me to buy half of what I bought before (i.e., my terms of trade have fallen by half), my per capita income would not have changed. In a less extreme proportion, this is what has happened to most producers of commodities in the last four years.

* Pedro-Pablo Kuczynski is Co-Chairman of First Boston International and a Managing Director of The First Boston Corporation. He has at various times served in the World Bank and the International Monetary Fund, in the private sector in the United States, and the Government of his country, Peru. The views expressed in this article are personal.
In earlier articles on Latin American Debt in Foreign Affairs (Winter 1982/83 and Fall 1983), Mr. Kuczynski assessed the dimensions of the oncoming debt problems of various Latin American countries and made suggestions to alleviate them.

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In Latin America, the subject of this article, various large and small debtors are on a treadmill, shuttling back and forth from the emergency room to the recovery room in the debt hospital. While the two largest debtors, Brazil and Mexico, look intermittently as if they are returning to the normal world, the growth crunch is still there. Last year the Latin American economy grew by only 1 percent and inflation averaged 165 percent. If the economic and political stresses continue much longer, serious consequences will follow for the debtors themselves while the credit markets of industrial countries could again be affected, as occurred in 1982.

The message in this paper is that the way out of slow development depends on action both in the debtor countries themselves and at the international level. It is not enough to rely only on one approach or the other: domestic and international action must be part of a concerted effort.

On the domestic front, the measures needed are well known but are difficult to implement, especially in the poorest countries, which are short of management and domestic savings. The most successful developing economies in the last twenty years, especially in East Asia, have been the ones which have maintained relatively free markets, realistic prices, especially the exchange rate and interest rates, as well as moderate taxation. They have encouraged agriculture and export-oriented industry while avoiding the economic asphyxia brought about by too many bureaucrats, endless regulations and state "enterprise". The word is spreading. Major developing countries, as diverse as India and Mexico, are starting to open up their economies and to reduce the role of the state by selling off government enterprises. The example of countries as different as

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conservative Britain and the United States on the one hand and socialist New Zealand and Spain on the other is turning the eighties into a decade of productive efficiency and industrial reorganization, albeit relatively slow growth.

For these efforts to succeed, however, the international economy and especially world trade in goods and services have to grow in order to provide enough new jobs. Western Europe today has 20 million unemployed, especially among the young, and in Latin America as well as Africa and South Asia the dead weight of joblessness is much worse. Although reliable data do not exist, it is conceivable that in some developing countries unemployment and underemployment affect half or more of the total labor force. The hopelessness created by prolonged unemployment and depressed incomes is fertile ground for extremism, including violence, political instability and the ever-present mirage of Marxist theory turned into economic practice.

The key point of this paper is that the re-establishment of growth and the move towards more efficient and incentive-oriented economies require in the first instance much more effective international public action and public capital flows than in recent years. This seems a paradox. However, private capital, both domestic and foreign, is bound to be cautious for some time. Until that changes, capital has to be mobilized in part through existing well-organized public institutions. The sooner the effort begins, the sooner hard-pressed economies can move towards greater reliance on the market. Much can be done without substantial additional money and borrowing.

At the annual meetings of the International Monetary Fund and the World Bank held in Seoul in October, the United States government took a

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major step forward when it implicitly recognized that the approach which it endorsed in the previous three years for the major debtor countries, namely a combination of austerity with some balance of payments credits, is no longer enough. Although the initiative of Secretary of the Treasury James Baker remains of necessity somewhat vague, because of internal political constraints in the United States, and requires much concrete work to be turned into practical action, it is nevertheless an important step. I will return to the Baker initiative later in this article.

* * *

The international environment for the recovery of the major developing country debtors, most of which - with the exceptions of the Philippines and Nigeria - are in Latin America, is not a good one: only modest growth in the industrial world as a whole, relatively high real interest rates and depressed commodity prices. Any concerted action to help the debtors has to recognize these limitations. Otherwise, unrealistic expectations and frustration will be created.

The 'eighties are likely to be a period of relatively slow growth in the world economy, largely because a combination of still relatively high energy prices and effective interest rates has put a premium on efficiency and flexibility as opposed to large-scale capital-intensive investment in heavy industry and in infrastructure. For the developing countries several features of this new environment are of special relevance: slow economic growth in the industrial countries as a group, relatively stagnant markets for most commodities and raw materials, increasing competition in basic industrial products which are becoming increasingly "commoditized", and the prospect of rising protectionism, at least for a time, as older industries

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in the industrialized countries are gradually squeezed out because they are no longer internationally competitive.

No amount of calculations and projections can get away from the fact that the foundations for international economic growth in the next few years, and perhaps even into the 'nineties, are shaky. Much of the stimulus of the last two-and-a-half years has come from the United States, where quasi-Keynesian fiscal policies, expecially a growing budget deficit one-third funded from abroad, have pushed up consumer demand and investment in services and in new industries. A high dollar has attracted a record volume of industrial imports from developed and developing countries alike. In 1984, these additional exports to the U.S. market added a range of between 1.5 and 3 percent to G.N.P. growth in Western European countries in 1984, greatly improving their economic growth.[2] Latin American countries, especially Brazil, were also able to benefit significantly, but lost markets elsewhere because their exchange rates, linked to the U.S. dollar, lost competitiveness against the Yen and the European currencies.

This unusual combination of forces cannot be expected to continue indefinitely. For one thing, the imbalance between relatively fast U.S. and Japanese growth and virtual recession in Europe will in time even out, but probably less through a renaissance of European growth than because of an expected cyclical downturn in the United States in the next year or so. This means only modest growth in world trade and the continuation of generally high levels of unemployment worldwide.

For the commodity-producing developing countries, including all of Africa, much of Latin America and some of Asia, the lack of strong stimulus from the North is depressing the prices of most commodities. The average

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[2] See, for example, Morgan Guaranty Trust Company of New York, World Financial Markets, December 1984.

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car or light truck built in the United States today uses 2,600 pounds of steel versus 3,500 ten years ago; per unit of Gross National Product, the industrialized countries today use one-third less metals than at the start of the energy crisis;[3] substitutes, stimulated by the need to conserve energy and by the spread of technological information, are making headway against traditional products such as cane sugar, copper, and even aluminum.

These forces--energy conservation and much improved access to technology--have coincided in time in the late 'seventies and early 'eighties with relatively slow economic growth, so that there is little reason to expect a commodity boom for quite some time. Commodity producing developing countries cannot therefore now look to a "Deus ex machina" to save their economic prospects, as occurred in the wake of the Korean War in the early 'fifties, of Vietnam in the second half of the 'sixties, or of the energy crisis in the early and late 'seventies. The same is true of most commodity producers worldwide.

A quick glance at the numbers below shows the long-term decline in world economic growth and in the expansion of world trade in the last fifteen years. By its end, the decade of the 'eighties could turn out to be that of slowest growth since the 'thirties. The combination in the 'eighties of slow world economic growth, lagging purchasing power of commodity exports (measured in simplified form by the terms of trade) with the high burden of servicing the interest on the external debt spells a sobering and perhaps bleak outlook for commodity exporters in general and for the highly indebted among the developing countries in particular.

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[3] See, for example, The Economist, August 11, 1984, "A boom that is not animal, vegetable or mineral".

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(average annual percentage changes)

	1950-59	1960-69	1970-79	1980-85
GNP Growth				
O.E.C.D.	6.0	5.1	3.2	1.9
Developing countries	6.0	5.6	4.9	1.5
Latin America	5.9	6.4	6.2	1.4
Terms of Trade of: Developing Countries				
Oil Exporters	-0.5	1.5	4.0	7.5[1]
Oil Importers	5.0	0.5	-2.0	-6.5
Merchandise Export Growth (in real terms)				
O.E.C.D.	10.3	8.5	5.8	3.2
Developing Countries	7.5	7.0	5.0	0.1
Latin America	5.6	3.1	3.5	2.9
Interest as percentage of annual merchandise exports (estimated)				
Latin America	5.0	8.0	20.0	40.0

[1] 0.2 for period 1981-85.

Source: Derived by author from World Bank, World Development Report, various issues; International Monetary Fund, World Economic Outlook, various issues; plus author's estimates.

The restructuring of industries, which is needed in order to improve economic prospects, is difficult for everyone, be it Big Steel in the United States, shipyards in Europe, or plantations and mines in tropical countries. The prospects for shifting successfully into new ventures are made even harder by the fact that in the late twentieth century the natural tendency for maturing industrial products to behave increasingly as commodities has accelerated. The ease of entry of new competitors--because of increasing access to technology and the ease of financing, plus the large

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role of governments in developing countries in industry and mining--has created oversupply in products such as petrochemicals, copper and steel, without effective incentives to correct the imbalance. Everyone loses: the old industries which can no longer compete because of older equipment combined with high labor costs, and many although not all the new entrants, most of them in developing countries, because of the high cost of amortizing expensive new plants and of servicing the debt.

Oversupply, the increasing "commoditization" of industrial products, and a slow-growing world economy, have created a large inventory of capital investment projects which have negative returns. Worldwide, many expensive nuclear and other energy projects, which were undertaken when it seemed safe to assume a rising price for oil, now stand half completed because there is not enough demand or enough capital to complete the investments. The drag of these now bad investments upon development prospects is considerable.

In the meantime, there is an inevitable long-term shift of older industries away from their countries of origin to newer lower-cost producers, a shift that has been going on since India took over from Britain as a major textile exporter to Asia in the late nineteenth century.* The relocation of industry has accelerated in the last decade and is creating strong protectionist pressures in the industrial countries.

The free trade system is now threatened. It flourished after the Second World War partly because of bad memories of the 'thirties, particularly the intensificaton of the depression caused by the Smoot-Hawley

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* Sir W. Arthur Lewis, The Evolution of the International Economic Order, Princeton, 1978, See Chap. 2. ff.

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tariff in the United States and by similar measures elsewhere. Another important underpinning of free trade was that there were very few important players in international trade in the two decades after the end of World War II. While it is true that the recent decline of the U.S. dollar will, after a lag, reduce protectionist pressures in the United States, the underlying protectionist trend has long-term origins which are not easy to uproot.

Thus, the relatively upbeat and comfortable setting of the world economy which existed in the 'fifties, 'sixties and early 'seventies has changed. No amount of prophesying and elaborate projections can change the fact that the world economy faces a period of slow growth. This outlook need not spell doom for economies that have shown flexibility and adaptability, such as those of East Asia--because of efficient low-cost investment, a motivated labor force and the lack of excessive regulation upon management--but it is particularly disturbing for countries and industries that are already in trouble.

For the highly indebted developing countries, most of them in Latin America, this setting is worrisome, particularly in light of what they have been through in recent years:

- A per capita income decline of between 12 to 15 percent, concentrated among the volatile urban masses of Latin America, whose decline has been even bigger. This is equivalent to per capita income in the United States falling from about $13,000 in 1981 to $11,000 today, but with the difference that in the debtor countries income levels were low to begin with.

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- Massive cuts in private investment, major public works and imports. Imports fell as much as 45 percent between 1981 and 1983 in Latin America, in order to restore viability to the balance of payments.
- A significant decline in the terms of trade of commodity-exporting developing countries. According to World Bank statistics[5], the prices of major commodities other than oil in the period 1981-85 have reached their lowest level in real terms in the last forty years. The decline in the terms of trade means that the same amount of dollar commodity exports as five years ago buys 25 percent less dollar imports. In the case of countries relying heavily on copper or sugar exports, the decline has been much greater.
- In Latin America, the burden of servicing interest alone on the external debt is so large that the only way it has been met since 1982 has been through the creation of very large trade surpluses, themselves the result of the sharp decline of imports and hence of domestic growth. In 1984, interest payments were equivalent to almost 45 percent of merchandise export earnings: since the trade surplus was almost of the same size, or more than twice the trade surplus of

[5] World Bank, The Outlook for Primary Commodities 1984 to 1995, Washington, December 1984. See table 9. The recent decline of the U.S. dollar has had no perceptible upward effect on dollar commodity prices, contrary to expectations.

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Japan in relative terms, most countries were able to get by without major capital inflows: in 1984, net international commercial bank lending to Latin American countries rose by only about 1 percent.[6]

Unfortunately, the strategy of relying on large trade surpluses and low capital inflows is unlikely to be viable in the long or even medium term. Trade surpluses are likely to be impermanent: either they will erode as growth and demand for imports resume or they could be affected on the side of exports if there is a weakening in the world economy. Already a downturn of exports has occurred in the three largest Latin American economies in the first months of 1985; notably, growth has also slackened off visibly in the normally dynamic countries of East Asia.

These problems come at a time of very rapid growth in the labor force, of around 3 percent in Brazil, Mexico and most of South and Central America. Such rapid rates of increase reflect the population boom of fifteen to twenty years ago; since then, of course, birth rates have fallen off somewhat in Latin America but the results will not affect the labor force for another decade or so. In the meantime, the suffering and frustration caused by the crisis is probably greater than measured by the per capita income decline: as a result of growing unemployment, the income per potential wage earner has fallen proportionately more than the income per inhabitant. Moreover, the frustration comes after the rapidly rising expectations of the 'seventies. Rampant unemployment, ubiquitous street vendors, and rapidly rising crime rates are the outward manifestations of a problem that is not fully understood.

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[6] International bank claims as reported in Morgan Guaranty Trust, World Financial Markets, July 1985. Data based on Bank for International Settlements, and others.

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Despite the depression in many debtor countries and their questionable economic outlook, the relative neglect, at least until recently, by the United States and the governments of other industrialized countries of a more concerted attack on the problems of debtor nations has so far not been catastrophic. Market mechanisms have been successful in containing the immediate financial crisis. The containment operation, stimulated by the Federal Reserve and the International Monetary Fund, was largely successful because of the tough austerity measures taken by most of the debtor countries in Latin America, whose leaderships were willing to face great unpopularity because they knew there was no alternative after the money had run out. Some countries delayed the moment of truth with the result that they were in even worse shape when the austerity measures had to be taken anyway.

But there is now an urgent need for a next step. The growth which many analysts had expected is in question. Major debtor countries are now into their fourth or fifth year of economic depression. Does anyone seriously think that this state of affairs can continue unchanged for much longer?

Two distinct sets of views exist about the future. There are those who think that major new institutional changes are needed, such as massive official refinancing of commercial bank debts, a new "Marshall Plan" for developing countries, and so on. Then there are those who think that everything will work out as long as there is enough economic growth in the world. The first make unrealistic assumptions about what governments and parliaments in the industrial countries will accept. The second do not allow

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enough margin for error in their projections and seem implicitly to believe a rather curious notion, namely that economic development can take place in savings-poor countries without major capital inflows.

In order to try to build a plan of action which would improve future prospects for indebted developing countries, I believe that three tasks should be tackled concurrently: first, to accelerate the restructuring of the economies of debtor countries in order to make them more efficient, productive and competitive internationally; second, to find ways to ease the immediate burden of interest service on the external debt; and third, to promote larger capital inflows from the outside. All three prescriptions are interrelated and none can work by itself. For example, lack of action in debtor countries would make it impossible to promote capital inflows; at the same time, lack of a visible source of expanded capital inflows would weaken internal support in the debtor countries for basic reforms. In other words, action has to be part of a coordinated policy package. The necessary resources, both domestically and internationally, cannot be mobilized on a piecemeal basis.

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The Baker initiative in Seoul takes up the first and third of these subjects. On the question of larger capital inflows to "principal debtors" among developing countries[7], the initiative suggested mainly a 50 per cent increase in disbursements from the World Bank and the Interamerican Development Bank to those debtors plus the maintenance of some net flow from commercial banks. The targets are modest in economic terms. The question of interest relief is a far thornier issue, not taken up in the initiative, but which clearly was on the minds of many, both lenders and debtors, at the Seoul meeting.

* * *

The problems of domestic economic restructuring in developing economies are at least as complex as what has been happening to steel and other heavy industries in Europe and the United States. These problems are even more difficult in poor countries, which lack the resources to absorb change. In addition, while there is a significant private sector in virtually all the economies of Latin America, the Spanish colonial tradition of special concessions and monopolies for particular enterprises as well as other protected economic privileges, which lasted for almost three centuries of Spanish rule and continued well into the present century, dies hard. There is thus a big difference between apparent private business and effective entrepreneurship.

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[7] These debtors are generally considered to be Argentina, Brazil, Chile, Ecuador, Mexico, Peru and Venezuela, plus the Philippines and Nigeria. There are many other developing countries, however, which can legitimately claim to be debt cases, ranging from Egypt to many of the Sub-Saharan African countries. Objective standards to define "high debtors" therefore have to be agreed before special programs for such countries can be organized in an orderly way.

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Private businessmen, especially in some of the smaller economies, are not infrequently the keepers of a privilege granted by the State, through a tariff, a de facto concession or a regulated price, rather than Schumpeterian entrepreneurs fighting it out in the marketplace.

These historical reasons, especially important in Spanish America, plus the small size of most domestic markets (the G.N.P. of the whole of Latin America is about that of the Federal Republic of Germany, while the average Central American country has a national market comparable to that of Albuquerque, New Mexico or Newark, New Jersey) explains in part why the bracing wind of competition and privatization of enterprise are not universally accepted in Latin America. Only one country, Chile, has in recent years successfully opened up its economy in a major way and sharply reduced the role of the state in production and distribution. However, the applicability of its experiment to other countries has been reduced by the present unusually centralized political system of Chile and by the fact that this opening up was accompanied by excessive external borrowing, induced by a policy from 1979 to 1981 of increasing overvaluation of the peso.

Nonetheless, the debt crisis has created an increasing awareness that the past emphasis on state "enterprise" has gone too far. The public correctly perceives that much of the excess external borrowing of the last decade was due to the profligacy of state-run companies, which continue to be bloated and inefficient at a time of sacrifice for the population at large.* In Argentina, Brazil, Mexico as well as other Latin American countries, "privatization" of some of these enterprises has become a topic for lively debate.

* Bureaucratic bloat is not limited to state enterprises. As a random example of bureaucracy in a central government, the Programming and Budgeting Ministry of Mexico, created in 1976 to control public spending, had grown to 16,000 employees before the public employment cuts made by the Mexican government in mid-1985.

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In this, as in the subject of the overall liberalization of economies, change is not easy. Enthusiasts sometimes forget that many developing country governments lack the most elementary services needed for an economy to operate.

Listening to the advocates of instant liberalization, one sometimes get the feeling that they are like physical fitness nuts, who might prescribe for a sedentary cardiac patient an instant get-well regime of jogging up and down the stairs.

Privatization can be successful if it is carried out with realism. One of the requirements is to educate politicians, so that they do not think, as some do now, that assets should necessarily be sold for anything approaching their book value or replacement cost. The disposition of a loss-making asset at "fire sale" prices may save taxpayers far more money than hanging on for a turn-around that never comes. Specialized international agencies, such as the International Finance Corporation of the World Bank, can help in setting the stage for privatization, but the temptation of governments to call them in as a substitute for action should be resisted: often inaction is fostered by requirements for lengthy studies and by unrealistically complicated bidding procedures.

The careful opening up of economies--through a combination of consistently realistic exchange rates with lower barriers to imports of goods, services and technology--is an obvious high priority. It would foster entrepreneurship, efficiency, and a greater long-term ability to compete with imports and to expand exports. It would also attract foreign investment and would stimulate the reflow of flight capital. The message is not in dispute and a number of countries have in recent years moved in that direction. The important point is that a more open trading system cannot be

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pursued unless there is a well-established and consistent policy of realistic exchange rates. The success of Brazil in expanding its industrial exports as rapidly as the East Asian countries is testimony to the benefits of a realistic exchange rate policy over a long period. Without such a policy, as has been shown in a number of cases in the last two decades, liberalization is not believed and merely stimulates a speculative import binge. Such an event would imperil the already feeble debt-servicing capacity of most highly-indebted countries.

Liberalization and privatization of economies are an urgent and most important priority. The task has to be undertaken in full awareness of the considerable historical, political and economic obstacles in the way. To the extent that the balance of payments constraint can be eased, at least partially, then the chances of new economic polices succeeding are greater.

* * *

The interest burden on the external debt is a major issue in most Latin American countries, even though international interest rates have moderated after a run-up in 1984. There are several economic reasons for this concern: the shortage of external capital flows, which has made it necessary to maintain large trade surpluses and hence to keep imports and economic growth down; the lack of growth itself, combined with persistently high inflation in major economies; the unfavorable outlook for traditional exports as well as the increasing threat of protectionism on more recent manufactured exports; and the very large fiscal burden of servicing the debt, which puts pressure on governments to raise taxes, most of which are indirect and thus inflationary in their initial application.

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The interest due to commercial banks by Latin American debtors in 1985, virtually all at variable rates, is on the order of U.S. $30 billion, of which about one-tenth is for trade-related credit. The $30 billion is equivalent to about 30 percent of merchandise export earnings, and to this sum must be added another $10 billion or so for fixed rate obligations to bondholders and official creditors. Beyond the internal pressures which could erode the trade surpluses which make it possible for countries to pay such a large bill, there are possible international developments which might make it inevitable for some debtors to delay interest payments, such as a slowdown in the world economy, an increase in international interest rates and an increase in protectionism.

Politically, the pressures for more expansionist policies, which could quickly dissolve trade surpluses, are also increasing in a number of countries. This is especially so in the debtor countries with large middle classes, as is the case in much of Latin America as well as the Philippines. The new government in Brazil is keenly interested in the renewal of economic growth. As the Mexican adminstration enters into the traditionally more expansionist second half of its term, especially after the recent catastrophic earthquake, similar pressures are likely there. The new government in Peru, caught in a tight financial squeeze, is looking for a new way out, in part by unilaterally limiting debt service to 10 percent of exports. In Panama, where more orthodox economic policies have been pursued by the new civilian government, the military seeks a significant economic relaxation and in September forced out the first elected President since 1968, who had been in office barely a year. Several large debtors who are also oil exporters, such as Nigeria, caught in an unexpectedly prolonged export price decline, are also facing similar pressures. It is questionable

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whether expansionist policies to revive growth can ultimately succeed, in the absence of large additional resources, but it is clear that the patience with the status quo is eroding in many countries.

It is therefore important to have in place before the event the main points of an acceptable contingent scheme to provide interest relief. This does not necessarily mean that such a scheme would have to be put into effect, but its outline would at least have to be ready. It was difficult enough for hundreds of banks to defer principal repayments by debtors in 1982-84: it would be far more difficult and complicated to face the sudden deferral of interest. Under normal accounting and banking regulatory practices, the non-payment of interest after a time entails charges against the income of lenders, because of the need to write off or reserve against loans. Any formula which defers interest therefore must first be acceptable to the regulators if it is to be considered by the lenders. The focal point for thinking about any future arrangements therefore has to be, on the side of lenders, within the key three or four central banks in the banking capitals of the world as well as a small number of the very largest international commercial banks,* and, on the side of debtor nations, an informal group among them. There are signs that such a process has already begun.

* In "LDC Debt: Where do we go from here?", Anthony M. Solomon, former President of the Federal Reserve Bank urges bankers "to search fairly speedily for a consensus on the nature of the concessions they could live with", although he is against formal contingency planning. See The Banker, London, August 1985.

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Among the many ways which have been publicly discussed to provide interest relief, two are perhaps the most practical. One would involve setting up a special window in the I.M.F. similar to the Oil Facility of the 'seventies, which would finance the interest above a certain level. Such a system would provide short-term protection against large increases of the type that occurred in 1981-1982. One conceptual objection is the idea of borrowing to pay interest, with nothing to show in the future for the borrowing: already, one-third, or $30 billion of the $90 billion increase in the external debt of Latin America in 1981-82, was the amount of borrowing which took place to pay the increases in interest in 1981-82. A much more practical objection is that it would be next to impossible in the prevailing political climate in the large industrialized countries to raise significant public funds for such a purpose.

A more market-oriented mechanism would therefore be a more practical way to envisage an eventual reduction of the interest burden. The adjustable rate mortgage loan system in the United States, which has grown in a few years to about $230 billion in outstanding mortgages, may provide a useful example for study. The system enables lenders to book market interest rates as income even though they may be receiving lower rates as effective payments during an initial period of up to five years. Unlike other capitalization schemes, such loans do not push back the whole capitalized amount to the end, but instead make the capitalized portion repayable gradually.

Clearly, the design of an adjustable rate system for international loans could not be undertaken without clear cooperation from the banking regulators. If that could be obtained, the initial savings of a broadly similar arrangement could be substantial for debtors, and at bearable cost

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for the lenders. For example, a three percentage point interest rate reduction on medium-term Latin American government debt to banks would, while it lasted, save about $6 billion annually in the initial years, a very significant sum indeed, equivalent to 1.2 percent of GNP, 6 percent of export earnings, or half the recent level of net capital inflows. It is equally clear, however, that there would be costs for the lenders, especially at the beginning, when cash flow is unlikely to cover the whole cost of money even though profits might be shown on the books. Clearly, no contingent scheme can be planned without public action on the side of the regulators to recognize that existing bank assets in high debt countries can improve in quality only if the immediate heavy burden of interest payments can be reduced.

Another avenue which is worth exploring and has in fact been applied in a number of company external debts is to transform debt into equity, giving the lenders a stake in the debtors through straight equity, or some form of preferred shares or subordinated debt. It is not possible to apply such an idea across-the-board to government debts nor is there the slightest chance that governments would even consider trading part of their debts for a foreign stake in a Pemex or a Petrobras, but the idea could be partially applied to private sector debts and some state company debts.

* * *

Interest relief alone is not enough. There must be more funds for development. If all three pieces of the program--interest relief, restructuring of economies, and more capital inflows--can come together, then there is a chance of improving an otherwise gloomy trend for high debtors. However, the last component, additional capital, may be the hardest to obtain.

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The largest reservoir of funds available to the debtor countries is the capital flight which occurred during the period of high external borrowing. The two are linked. Much of the money borrowed from commercial banks fled, not because private citizens are evil but because economic incentives, especially overvalued exchange rates, made it attractive for them. The perhaps $80 billion or so which fled Latin America from 1970 to now are the single largest resource which would help the balance of payments of the region. But the money will not begin to return until there is a period of consistent and realistic economic policies. Thus, the repatriation of capital is not necessarily a distant bonus, but a necessity. Without it, foreign direct investment will be slow to revive from the low levels it has reached.[19] The reason is simple: foreign corporations are understandably reluctant to put money into countries from which their local partners are withdrawing.

Special insurance arrangements, such as the Multilateral Investment Guarantee Agency (MIGA, or "crumb" in Spanish) just approved by the World Bank, can help in time. However, the results will not be visible for some years, and they will not be forthcoming unless the overall economic outlook improves. Therefore, foreign investment, while continuing to be very important in terms of technology and efficiency transfers, is likely to be a follower rather than a leader in a recovery in the high debt commodity-producing countries.

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19 Net direct investment flows into seven major developing countries (the four largest Latin American countries, plus Indonesia, Korea and the Philippines) fell from a peak of $6.3 billion in 1981 to $2.6 billion in 1985. See International Monetary Fund, Foreign Private Investment in Developing Countries, Washington, D.C., January 1985.

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Capital inflows into poor and highly indebted countries must thus come initially from public sources. To make such a statement generates strong ideological reactions in an age of deregulation, privatization and troubled industries and regions in the industrialized countries. Yet, as the case of Central America demonstrates, governments are likely to put up large amounts of public funds if they perceive an emergency.

The one source of capital flows with so far unrealized potential is from multilateral development banks. First, they have relatively large cash reserves, particularly in the case of the World Bank, which could support larger disbursements in the short run. Second, the capital that they need to continue expanding their borrowing from private markets can be supplied almost entirely in the form of non-cash guarantees by their shareholding governments. In its forty years of existence, the World Bank has never had to rely on the guarantees or "callable capital" supplied by its shareholders and, like the InterAmerican and the Asian Development banks, it has never had a significant default. In the last two years, all three institutions have increased their disbursements somewhat, but the overall sum remains relatively modest (about $3 billion net of amortization in Latin America in the current fiscal year) not because of its absolute size but because of the dearth of financing from other sources. The World Bank has attempted to put emphasis on "structural adjustment loans," which provide import finance for development programs in exchange for economic policy reforms by governments. There has been considerable resistance on the part of governments to accept such programs on top of the requirements of the International Monetary Fund.

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Two points are important in designing a new role of the multilateral development banks towards the high debt countries. First, the temptation should be resisted to encourage development banks to play the role of the International Monetary Fund, by giving general purpose balance-of-payments loans backed by financial performance targets on the part of the borrowers. That it is the role of the Fund. To promote the entry of the development banks into this field, which they are not organized to handle, would not only devalue the quality of their assets but would also create the illusion among some borrowers that there is an option with "softer" conditions. Admittedly, Fund programs have often been harsh and sometimes ineffective, but the main reason for this failing has been the lack of significant capital inflows. A revival of such inflows would automatically ease the toughness of the programs. Just as there is no alternative to austerity when the money runs out, so also there can be no recovery without the oxygen of capital inflows.

Second, a distinction has to be made between what is possible now and what can be done in the medium term. The problems of many debtors are immediate. The additional capital inflows recommended in the Baker initiative are needed now. New loans, which take a long time to negotiate, would provide funds in a year or two at best. While a medium-term plan is worked out, including sector loans, the multilateral development banks could make a significant impact by sharply increasing disbursements on already approved projects, many of which have been slowed down because debtor governments do not have the local currency to cover their share of the costs. Typically, the multilateral banks cover about 40 per cent of project costs. If countries accepted some form of surveillance by the International Monetary Fund, either directly or, as was recently agreed with Colombia.

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indirectly through "monitoring" of financial targets, a basis would exist to combine financial discipline with more development lending in the near future. But the capital inflow targets would probably have to be higher than in the Baker initiative. The projects are good, they generate real economic benefits, including substantial employment, and their acceleration would provide an image of dynamism badly needed by debtor governments.

To move ahead in such a direction, however, requires political suport. In the United States and in other industrialized countries, beset with their own internal problems, political support for international initiatives is scarce indeed. The quota increase for the Fund barely squeaked through the U.S. Congress in 1983 and a number of Republican Congressmen who voted for it lost their seats as a result of an aggressive lobby against them. That is why the Baker initiative rightly asks the commercial banks to continue lending, albeit at a modest rate of 2.5 percent additional per year. Even such a level of lending will be extremely difficult, however, unless there is an easing of the regulatory strictures described below. Trade finance, where the loan cutbacks have occurred in the last three years, is the area where the greatest potential exists for renewed lending by banks: it is backed by hard exports and imports and would help countries expand their exports.

* * *

How can the three parts of a new approach--economic reforms, new capital inflows, and interest policy--be put together? Will a new crisis have to occur first? Unfortunately, several factors militate against timely preventive policies. First, the lenders themselves, worried as they may be, have for the last three years put a good face on what they acknowledged to be a difficult problem. So much publicity has been invested in saying that there was no big problem that an about-face is now difficult.

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The banks face several difficulties not of their own making. First, their stock prices are at low levels and prevent them from adding to capital in the most economical way through the equity market. Second, the banks have been the subject of conflicting signals from their regulators, especially in the United States: on the one hand the Federal Reserve, in its role of international monetary statesman, has been telling them to expand lending to troubled countries that tried to get their affairs in order, while on the other hand, the Fed itself, plus Congress, the Securities and Exchange Commission, and the Comptroller of the Currency have imposed disclosure and capital requirements which make it very difficult for banks to ease troubled customers back to health, domestically or abroad. Additional regulatory demands are likely in the near future, including calls to expand bank capital. Third, this pluralistic policy-making has coincided with a more-than-normal wave of feeling against foreigners, third world nations and the materially unsuccessful in general. In addition, serious economic problems in Europe, because of stagnation and sick industries, and in the United States, because of the political difficulties of reducing the budget deficit, naturally receive priority attention as opposed to more distant issues which may perhaps one day become crises but do not yet look like crises.

There is thus little to induce policy makers in the major creditor countries to focus on preventive action. The Baker initiative fortunately has broken this pattern. For it to succeed, further work is needed to flesh it out. The clear support of other industrialized country governments is essential. The major debtors, especially Brazil and Mexico, could play a key role in tilting the balance. Before any wider meetings are called, it would be important to get clear agreement among a small number of creditors

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and debtors on a few basic working assumptions without which the design of further action would not be possible. Among these basic precepts are:

- The problems of the highly indebted countries, most of which are very dependent on commodity exports, are long-term ones and cannot be alleviated only through financial stabilization programs accompanied by modest lending from abroad.
- Most of the debtor governments have made major efforts to adjust to the new austerity, but external financial support for these efforts has been inadequate. The continuation of financial discipline and the beginning of basic economic reform require more external support, especially from international public sources in the next few years.
- This support can be obtained with minimum funds from taxpayers by substantially expanding the disbursement and lending and, in time, the callable capital of the multilateral development banks.
- To the extent that capital inflows can be effectively stimulated, the need for large-scale interest relief will be less, but it is still desirable to plan some interest relief, at least on a contingent basis. Existing market mechanisms provide an example which might be helpful.

A plan such as the one outlined here will not by itself turn the high debtor countries to instant health. But it may be the ray of hope that alleviates the increasing strains of recent months. Certainly, after the initiative of the United States government in Seoul, there is no going back. The only question is how to turn these proposals into concrete action with all due deliberate speed.

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